



Институт за икономическа политика  
Economic Policy Institute



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# **The Bulgarian Competitiveness during the Crisis – Challenges and Possible Solutions**

Sofia  
2009

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Sofia, 1463, 2 Khan Asparouh Str., Fl.3

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**Cover & Body Design, Prepress:** *Latchezar Marinopolski, "Ni Plus" PH*

**Print:** *Simolini 94 Co.*

This publication contains shortened and revised versions of the presentations delivered within the conference "The Bulgarian Competitiveness during the Crisis – Challenges and Possible Solutions", organized by the Economic Policy Institute (EPI), Sofia and the Hanns Seidel Foundation, Bulgaria on March 18, 2009 in Sofia. Short summarizing reviews of the four areas revealed, providing latest available data, are also included.

The current issue is made possible thanks to the kind support of the Hanns Seidel Foundation, Bulgaria. The findings, interpretations and conclusions here are those of the authors and do not necessarily reflect the views of the Economic Policy Institute, the Hanns Seidel Foundation, Bulgaria or the institutions they represent.

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**ISBN:** 978-954-9359-39-8

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## INTRODUCTION

National competitiveness is a very complex reality to be easily measured. There are several important components of competitiveness. Competitiveness is at the centre of many analyses applying different approaches to evaluate it. Usually, the main focus is put on changes of productivity growth as a key driver of competitiveness in the long run.

In recent years, for comparative studies analysts use the Global Competitiveness Indexes of the World Economic Forum as a representative tool, evaluating a weighted average of many different components, each of which reflects one aspect of competitiveness of 134 countries. These components are grouped into 12 pillars of economic competitiveness. To the Basic requirements belong Institutions, Infrastructure, Macroeconomic stability and Health and primary education, which are of key importance for factor-driven economies. As Efficiency enhancers into the Global Competitiveness Index are incorporated: Higher education and training, Goods market efficiency, Labor market efficiency, Financial market sophistication, Technological readiness, Market size. These components are crucial for efficiency-driven economies. As Innovation and sophistication factors the Global Competitiveness Index includes Business sophistication and Innovation.

In this Report the stage of development of Bulgaria is characterized as efficiency-driven. In comparison, for Finland, Denmark, the Czech Republic, etc. this characteristic is innovation driven, Estonia is in a transition from an efficiency-driven to an innovation-driven economy.

Bulgaria is ranked 76<sup>th</sup> in the Overall Global Competitiveness

Index. In the first pillar, Institutions, there are three indicators very important for Bulgaria. The first one is Public trust in politicians. Denmark is ranked 2<sup>nd</sup>, Finland 3<sup>rd</sup>, Estonia 44<sup>th</sup>, Bulgaria 112<sup>th</sup>, the Czech Republic 117<sup>th</sup>. For the indicator Judicial independence Bulgaria is on the 110<sup>th</sup> place, Finland is 2<sup>nd</sup>, Denmark 5<sup>th</sup>, Estonia 27<sup>th</sup>, Czech Republic 61<sup>st</sup>.

In the second pillar, Infrastructure, the indicator Quality of overall infrastructure, presents the following rankings: Bulgaria is occupying the 109<sup>th</sup> place (Finland 5<sup>th</sup>, Denmark 7<sup>th</sup>, Estonia 37<sup>th</sup>, Czech Republic 51<sup>st</sup>).

The fourth pillar concerns Health and primary education. The indicator Quality of primary education places Bulgaria 79<sup>th</sup> (Finland 1<sup>st</sup>, Estonia 11<sup>th</sup>, Denmark 14<sup>th</sup>, and Czech Republic 15<sup>th</sup>).

The indicator Quality of the education system within the fifth pillar (Higher education and training) indicates that Bulgaria is ranked 81<sup>st</sup> (Finland 1<sup>st</sup>, Denmark 6<sup>th</sup>, Czech Republic 26<sup>th</sup>, Estonia 30<sup>th</sup>)

According to data on the indicator Brain drain (within the seventh pillar, Labor market efficiency), Bulgaria takes the 127<sup>th</sup> place (Finland 7<sup>th</sup>, Denmark 17<sup>th</sup>, Czech Republic 43<sup>rd</sup>, Estonia 46<sup>th</sup>).

Based on the considerable amount of Foreign Direct Investments (FDI) inflows to Bulgaria in recent years, it is interesting to assess their contribution to the efficiency of the economy. Within the ninth pillar on Technological readiness, the indicator FDI and technology transfer, Bulgaria is ranked 115<sup>th</sup>, which means that compared to the rest of the world FDI in Bulgaria have rarely been transferring technology to the country. (The same indicator for the Czech Republic is 13, for Estonia 25, for Denmark 41, for Finland 71.)

Within the 11<sup>th</sup> pillar on Business sophistication there is the indicator on Nature of competitive advantage. The advantage-

es of the Bulgarian economy are ranked 100<sup>th</sup>, while those of Denmark are on the 3<sup>rd</sup> place, of Finland on the 6<sup>th</sup> place, of the Czech Republic on the 48<sup>th</sup> place, of Estonia on 62<sup>nd</sup> place.

Innovation is the key not only for increasing competitiveness, but also for resisting the impact of the global economic crisis. According to the indicator Capacity of innovation (within the twelfth pillar), Bulgaria is on the 80<sup>th</sup> place (Finland on the 5<sup>th</sup> place, Denmark on the 7<sup>th</sup> place, the Czech Republic on the 24<sup>th</sup> place, Estonia on the 40<sup>th</sup> place). The indicator Company spending on research and development also shows that Bulgaria is ranked 101, which also suggests that foreign companies did not use the local human capacities for their research activities. University-industry research collaboration is also very low in comparative terms (92<sup>nd</sup> place for Bulgaria, 4<sup>th</sup> for Finland, 7<sup>th</sup> for Denmark, 26<sup>th</sup> for the Czech Republic, 29<sup>th</sup> for Estonia). Special attention has to be directed to the indicator Government procurement of advanced technological products, where Bulgaria is ranked 82<sup>nd</sup>, Finland 7<sup>th</sup>, Denmark 10<sup>th</sup>, Estonia 18<sup>th</sup>, the Czech Republic 35<sup>th</sup>. If we take the indicator Availability of scientists and engineers, we can realize the linkage with the indicator Brain drain. According to the availability of scientists and engineers, Bulgaria is on the 93<sup>rd</sup> place.

It is worth noting that according to the Global Competitiveness Indexes of the World Economic Forum the three most problematic factors for doing business in Bulgaria are corruption, inefficient government bureaucracy and inadequately educated workforce.

The IMD World Competitiveness Ranking is another source of information being a picture of competitiveness at a certain point of time. Simultaneously, it is also looking at the evolution of countries' performances over the longer period. Of

the 57 economies ranked by IMD, all of the Nordic economies have increased or maintained their rankings compared to the US: Denmark improves one rank to 5<sup>th</sup> position, Sweden moves up 3 places to 6<sup>th</sup>, and Finland, a huge bound from 15<sup>th</sup> place last year to 9<sup>th</sup> place. Norway maintains its 11<sup>th</sup> position. The most spectacular movement is seen for Estonia, falling 12 ranks to 35<sup>th</sup> place. Some countries suffered important reversals: Greece (52<sup>nd</sup>) falls 10 places, followed by Romania (from 45<sup>th</sup> to 54<sup>th</sup>). Other important declines include: Hungary (from 38<sup>th</sup> to 45<sup>th</sup>), Spain (from 33<sup>rd</sup> to 39<sup>th</sup>) and Ireland (from 12<sup>th</sup> to 19<sup>th</sup>). And to think that Ireland was ranked 5<sup>th</sup> in 2000!

According to the latest IMD's publication (World Competitiveness Yearbook, 2009 WCY Rankings, May, 2009), the competitiveness of the Bulgarian economy is ranked 38, one score higher than in 2008. More advanced positions are taken by Denmark (5<sup>th</sup>), Finland (9<sup>th</sup>), Austria (16<sup>th</sup>), Czech Republic (29<sup>th</sup>), Lithuania (31<sup>st</sup>), Slovenia (32<sup>nd</sup>), Slovak Republic (33<sup>rd</sup>), and Estonia (35<sup>th</sup>). Behind the competitiveness ranking position of Bulgaria are Poland (44<sup>th</sup>), Hungary (45<sup>th</sup>), Italy (50<sup>th</sup>), Greece (52<sup>nd</sup>), Croatia (53<sup>rd</sup>) and Romania (54<sup>th</sup>). The WCY relies strongly on hard statistical data, which represents 2/3 in the overall ranking (1/3 are opinion data). IMD's definition of competitiveness is: "How nations and businesses are managing the *totality of their competencies* to achieve greater prosperity". Competitiveness is not just about growth or economic performance but should take into consideration the "soft factors" of competitiveness, such as the environment, quality of life, technology, knowledge, etc. The research of IMD also shows that the size of economies is becoming more relevant and large populated economies present a different competitive model than smaller ones. Consequently, rankings split by population size (above and below 20 mln.) allow comparisons between countries that are of a similar size and compete in



the same “playing field”. (IMD World Competitiveness Yearbook 2009).

The present publication aims at expanding the empirical knowledge on the current state of competitiveness of the Bulgarian economy taking into account sector analyses, depth of competitiveness, factors influencing competitiveness, etc.

**Ivanka Petkova, PhD**

*Chairperson,*

*Economic Policy Institute*

# CHAPTER ONE

## **INVESTMENT POLICY AND EUROPEAN FUNDS**

## **Nina Radeva**

*Deputy Minister,*

*Ministry of Economy and Energy of the Republic of Bulgaria*

The main negative effect of the economic crisis for Bulgaria will find expression in the slowdown of the GDP growth rate, of the foreign capital inflows – both foreign direct investments (FDI) and investment activity based on mutual financing. Small and middle enterprises (SME) will be the most damaged as they are highly dependent on the crediting of their businesses.

The newly established as well as innovative companies will also suffer from financial insufficiency because in their first years credits are badly needed. The data from the Ministry of Finance indicates that this year nine new procedures are planned to start in their support with a total estimate of EUR 385,9 mln. EUR 250 mln. of them are expected to go to the SME in the country. The budget of five procedures within the program's framework is expanded by nearly BGN 100 mln. Unfortunately, if some of the resources are not absorbed in 2009, it will be extremely difficult to renegotiate them at a later stage.

Labor productivity growth could not be achieved without innovations. For its part, the increased labor productivity may turn the economic crisis into an opportunity. Unfortunately, our country may face significant difficulties regarding the implementation of the Operational Programme "Competitiveness". For the time being, the absorption rate of the resources available on the program from the Bulgarian business is unsatisfactory. There is nearly EUR 1,2 bln. in the European budget intended for the improvement of the competitiveness of our companies but these finances must be absorbed not later than 2013.

The third priority of the program for the establishment of guarantee funds, risk capital funds and micro crediting is yet

to start. Another option for Bulgaria is to participate in the program JEREMIE. It consists of a set of instruments aimed at creating improved access to financing for SME on national, regional and local level. This measure is envisaged for the period 2007-2013.

## **Stoyan Stalev**

*Executive Director,  
Invest Bulgaria Agency*

Only for the last three years EUR 21 bln. have been invested in Bulgaria, while for the whole period 1999 – 2000 they were around EUR 31 bln. Despite the increase during the last years, the country still lags behind with the FDI due to the poor state of the infrastructure. Bulgaria shares the bottom places in Europe when it comes to investments in infrastructure.

In comparison with the same period last year FDI have slumped by 30 % until January 2009 and they amount to EUR 250 mln. The inconclusive data gives grounds to expect 20 – 30 % annual decline in all investment fields. According to the initial data, for the last year investments in Bulgaria amount to EUR 6,163 bln. This is comparable with the 2006 level when they reached EUR 6,158 bln. For the time being, 2007 holds the record for investments when Bulgaria managed to attract EUR 8,488 bln. of foreign capital. The 2007 data have been revised and increased by EUR 1,5 bln. The same tendency, though on a smaller scale, could be expected for 2008.

The top investor in the country remains Austria with EUR 5,427 bln., i.e. 16 % of all investments in Bulgaria. It is worth mentioning that Austria is the biggest investor in Romania as well. The second place goes to the Netherlands by EUR 3,949 bln. (11 %), followed by Greece with EUR 3,07 bln. (9 %) and Great Britain with

EUR 2,741 bln. (8 %). The fifth position belongs to Germany with EUR 2,105 bln. or 6 %, which does not match with its status of the biggest trade partner of Bulgaria and reveals potential for future investments. Other countries with stable investment positions are Cyprus, Belgium and Luxemburg, the USA, Hungary and Italy.

The sector that managed to attract the largest share of the FDI is real estates with EUR 7,409 bln. or 22 % of all the investments. The other sectors that absorbed major investments are financial services (EUR 6,296 bln. or 19 %), infrastructure with EUR 6,225 bln. (19 %), trade (EUR 5,458 bln. or 17 %) and manufacture (EUR 2,131 bln. i.e. 6 %). Regardless of the increase in the last years, Bulgaria is in arrears with the FDI mainly because of the state of the infrastructure, which is a key factor for the overall attractiveness of the country.

Presently, Bulgaria must prioritize the attraction of investments in electronic engineering, electronics and auto parts, which could make it a supplier for the countries in the region. From the beginning of its foundation, Invest Bulgaria Agency has supported 113 projects with investments of EUR 9,2 bln. and 45 382 new workplaces created.

## **Boyko Dimitrachkov**

*Member of the Board of Management,  
E.ON Bulgaria EAD*

In times of crisis, several main factors are important for Bulgaria. These are greenfield investment projects that could largely contribute to the fast and less painful recovery of the country. Unfortunately, they are highly dependent on the signals that Bulgaria transmits to potential investors. They seek security, stability and

foreseeability, which our political environment failed to produce in the last 20 years. Troubled institutional environment resulted in a dysfunctional legal system.

The status of the labor force stands out as another problem – it used to be high qualified and cheap. Lately, a tendency towards its insufficiency and poor preparation has been observed. Additionally, quick ageing is in progress on the labor market and compared to other countries, the force becomes expensive.

Labor legislation in the country allows workers' or personnel dismissals only by mutual consent or under organizational changes, which leads to long-term employment. Consequently, this situation does not stimulate qualification improvement and productivity of labor.

Another serious disadvantage that prevents investment intentions from materializing is the bad physical infrastructure, which is key to Bulgarian and foreign investors alike. The loss of resources from the EU funds produces additional obstacles for its improvement.

A few measures must be adopted on governmental level in order to create favorable environment for doing business in Bulgaria. First of all, a clear position regarding the crisis must be held in public and then an explicit program must be prepared and implemented.

When it comes to solving all the cited problems, a matter of exceptional importance is the normalization of Bulgaria – EU relations. One should not underestimate the modernization of the educational system as it precedes and defines the structure and quality of the labor market. Its connection with the needs of the business and the economy should be made a priority.

**Mariana Trifonova**

*Project Assistant,*

*Economic Policy Institute*

### **(Summary and current trends)**

From the beginning of this year, as a result of the global economic crisis, we observe certain hesitation and caution on behalf of the foreign investors when it comes to the economies in Central and Southeastn Europe, which until recently rejoiced at significant investment interest. Even last year the drop in FDI for SEE was 22 % and the Vienna Institute of International Economic Analyses predicts their decline in 2009 to continue with at least 40 – 50%. For Bulgaria, in particular, the National Bank data from June, 17<sup>th</sup> indicate a dramatic slump in FDI for the period January – April 2009, which means that investments tantamount to EUR 955 mln. In comparison, for the same period last year the figures were EUR 1,9 bln. Although foreign capital in the country shrank up by 71 % in April 2009, quite a few analysts point out that Bulgaria is in a far more favorable position than Romania and it will not be the country in the region to be most affected by the crisis. Such claims are based on the competitive advantages of Bulgaria in view of the low taxes and the relatively smaller drop in FDI. A prove in this respect is the relatively small number of production capacities, property of transnational corporations, which were closed down in Bulgaria.

If we examine the preliminary data of the Bulgarian National Bank concerning investments by branches, we will notice a considerable stagnation in construction. Investments for the first quarter of the year equal to EUR 73,8 mln. (EUR 102,4 mln. for the period January – March last year). Although the eco-

conomic crisis undoubtedly has a very negative effect on the Bulgarian economy, the investments shrinkage in certain sectors such as construction that have experienced disproportional growth in recent years, may create new opportunities. They are related to the allocation of resources to other sectors and to the chance for further development.

In crisis conditions, the adequate governmental policy for attracting foreign investments is crucial and priority should be given to projects with high added value as energy supplies from alternative resources, information and communication technologies. The business conditions in Bulgaria are traditionally referred to as very attractive but flexible and creative policies should be implemented in order to prevent loss of investors from the country. In this respect, in June 2009, the government announced its intention to support foreign investments by constructing industrial zones and the first seven of them were supposed to be ready by the year's end. For this purpose, the National Company Industrial Zones was established. The financing is supposed to come from the state budget and the Operational Programme "Regional Development". An interest in the industrial parks is expected from Japan, China, India, Russia, Israel and the USA. However, for the time being, there are considerable and ubiquitous delays in all construction activities and the deadlines for the seven zones will not make exceptions.

Presently, in this delicate situation, it is very important to consider the potential risks in the implementation of such major projects. First, there is the danger of the industrial zones remaining empty. It is necessary to analyze whether their construction from the business to the business does not offer better chances for finding investors who will remain in them. Attention should be paid also to the precon-



ditions for financial losses to the exchequer due to public orders carried out incorrectly, misappropriations and corruption practices. Additionally, the new government declared reassessment of the economic profitability of major state-funded projects.

Government officials launched the idea for the state to start directly supporting investors by co-financing part of the investments – a measure that has been used for years in some of the old member states of the EU like the UK and Germany. The main obstacles for the adoption of such policies, however, are related predominantly to the concerns from the recent months about the budget balance. Earnings collection is 16 % lower than the envisaged one and if the tendencies in revenues and expenditures remain unchanged, a deficit of BGN 2,5 bln. is expected in the end of the year. According to its first fifteen anti-crisis measures, the government plans to support foreign investments by approving the “one desk service” in the Invest Bulgaria Agency as well as expanding its administrative rights in order to interact more intensively with the ministries. The measures also envisage a lowering in the threshold for investors whose projects could be co-financed by the state.

Another possible direction of the government’s investment policy is the mitigation of the shock from the drop in FDI by making good use of the reserves that exist with regard to the frozen European funds. On May 27<sup>th</sup>, 2009 the Minister for Economy and Energy signed with the European Investment Fund (EIF) a Framework and Financial agreement for the implementation of the JEREMIE Initiative in Bulgaria. This is expected to facilitate SME access to risk capital in niches where the bank financing is insufficient. EUR 200 mln. will be transferred from the EIF and they will be used for the capitalization of the specially established enterprise,

registered by the Bulgarian Development Bank. EIF will be the majority shareholder and it will manage the resources on behalf of and in favor of Bulgaria. The EIF is entitled to the refunds for management expenses of the Holding Fund but not to profits and dividends. The Holding Fund chooses its financial intermediaries on a competitive basis and they provide the approved financial products to the SME.

The quality and characteristics of the labor force are key factors for the attraction of foreign capitals and a special emphasis should be put on education. The cooperation between the educational institutions and the business in Bulgaria is still at a rather unsatisfactory level and the economic crisis additionally complicates the interaction between them. However, individual examples of common interest and good will do exist. For an instance, in June 2009 a cooperation agreement was signed between the Technical University, Sofia (TU) and the Bulgarian Chamber of Commerce and Industry. The aim is to improve the professional qualification of the students through additional training and then they, as prospective employees, will improve the competitiveness of the Bulgarian firms. For now, the cooperation agreement will have two particular forms. The first project is for the construction of a Techno park in TU campus, which will be complemented by a business incubator. The other initiative is related to the organizing of training courses with the active participation of specialists from Bulgarian and German companies as well as members of the German Chamber of Small and Middle Enterprises.

The establishment of university career centers from the Business Foundation for Education should also be associated with the good practices in this sphere. These centers provide consultative and information services to the students but maybe their main function is to facilitate the contact between the

young people and the large companies looking for their internship programs and junior positions personnel.

In summary, the economic crisis creates conditions for uncertainty and has strong negative impact on FDI inflows in the country. Possible counter actions should be sought in the improvement of European funds absorption as well as in the government's policies for additional stimulus of the investors' interest in Bulgaria. Along with the liabilities, the crisis opens opportunities for the realization of long-delayed reforms in numerous social spheres and for more efficient restructuring in some economic sectors.

# CHAPTER TWO

## **THE BULGARIAN EXPORT IN TIMES OF GLOBAL CRISIS**

## **Tsvetan Simeonov**

*Vice-President\**,

*Bulgarian Chamber of Commerce and Industry*

In a broader perspective, 2008 could be defined as a relatively successful year, with sufficient growth rate, both in export and in import. Eventually, the conclusions are not in favor of Bulgaria, as the trade deficit continues to grow. The positive signal that the Bulgarian Chamber of Commerce and Industry (BCCI) receives from investors, operating in the country, is that for the time being, if any production capacities need to be shut down, they would not be the Bulgarian ones. With reference to the coming into force of a bilateral agreement avoiding dual taxation, the American companies intensified their interest in the country, which is another positive aspect side. Specialists from both sides assess that this would additionally contribute to higher investment activity because in Bulgaria business conditions deteriorate slower in comparison with those in the USA.

The Bulgarian advantages consist also of its new position as an EU member state as well as a complex of other factors, for example its geographic crossroad position. Despite the negative impact of the economic downturn on such countries as Japan, they are still using the transit potential of Bulgaria. In this track of thoughts, however, one has to mention the necessity of priority improvement of the Bulgarian infrastructure (land roadbeds and ports).

The negative aspects of the crisis for Bulgaria are mainly related to its export. The latest data available shows a decline in beverages, plastics, etc. These are all sectors that until very recently were considered good opportunities for investments. Notable slump is observed in the trade relations with the neighboring countries.

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\* Since June 17<sup>th</sup>, 2009 Tsvetan Simeonov is elected President of the Bulgarian Chamber of Commerce and Industry

In the light of the upcoming stagnation in Western Europe the expectations for the demand of Bulgarian goods and services are not optimistic. A decline in the export for major foreign partner of Bulgaria like Italy.

A few conclusions could be drawn from the current situation. Firstly, there is a major discrepancy between the government's envisages for the export development and the reality. The initial preparation of the export development strategy has started in 2007 but currently there are no indicators for its further implementation. After all, this is an underlying document and its ascertainments are correct but some of the conclusions are not. In that perspective, various political parties, in the context of the forthcoming elections, seek signals from the business and its organizations in order to adopt some suggestions that could contribute to economic revival after their eventual coming into power.

A part of the mentioned above incorrect conclusions in the document is related to the functioning of the Bulgarian trade missions abroad. Still, the dominant point of view is the concept that their main duty is providing support services for the ministry representatives arriving for an official trip. That is an exceptionally wrong attitude that calls for a change. The responsibilities of those trade representatives should remain specifically economic – support for investors and measures aiming at general improvement of the business climate. In times of crisis, a change in their duties and responsibilities and strict control over their effectiveness are required. In the current situation, it is crucial to be flexible and to react instantaneously. Bulgaria is in the good position of a small open economy where changes could be easily achieved but the available resources must be utilized. It is appropriate to endorse monthly reports of the trade representatives in order to monitor the results of their work and if proved insufficient, immedi-

ate changes of the representatives should be made. If the new official fails to improve the performance of the department, the trade mission itself should be closed down.

A form of honorary representation also exists. Actually, these representatives do the same work. There is a good practice of sending trade representatives that actually provide for themselves and only in rare cases, they are given passports and an office within the diplomatic mission. Usually, they are even more efficient than the regular trade representatives. Although this may not be their only occupation, sometimes the foreign trade turnover with the countries in which they perform expands up to eight times. At the same time, the expenses for such a representative are up to ten times lower in comparison with the trade missions. Presently, Bulgaria has six trade missions abroad while within the institute of honorary representation we could cover three times all the countries in the world. In this sense, this is a significant tool that needs to be exploited properly.

Clearly, the export grows with considerably slower rate than the import and the trade deficit is larger and no significant improvement could be expected during 2009. Obviously, the crisis will not prevent the people from consuming – they will continue eating, drinking, and driving cars, although the latter will probably be more humble, with lower fuel consumption. As the demand will be limited, both the Bulgarian business and the relevant governing institutions must understand that the producers should not be unduly burdened with extra costs, waste of time for meeting some requirements, filling in documents and submission of information to numerous institutions. What is needed, is a reduction in the import and growth of the export; increase in the competitiveness of Bulgarian goods; improving the advertising for sale abroad; more efficient exploitation of the available resources; inclusion of NGOs in these processes.

The access to information and the participation opportunities for Bulgarian companies abroad have to be improved also by at least partial financing within the budget of the Bulgarian Small and Medium Enterprises Promotion Agency. Despite the expectations for the approaching start of the Operational Programme "Competitiveness", for the time being it does not function and a contract signed does not necessarily mean absorbed funds. Actually, in a situation of expanding crisis the companies that are in worsen conditions do not receive any support due to the insufficient performance of the administration.

Bulgaria could not take the advantage of an increase in the customs duties or other similar barriers against the unfair competition of imported goods. Therefore, opportunities for raising barriers against subsidizing, dumping products and lowered prices should be used. There are legal methods for restrained unfair competition. In Bulgaria a full awareness of those means does not yet exist as we are still in a process of exploring a whole new legal system – the EU *acquis*, containing set procedures versus dumping import and to prevent the access of such goods to the single market of the Union.

The government positions within its now operating program for an export development must be realistic. Only two industrial zones are included in it for the whole mandate of 4 years. Not to mention that Ruse industrial zone is completely used up and the other one nearby Plovdiv could be considered a semi-industrial zone. In this regard, it is unacceptable to discuss the set up of another 180 within a year and a half. These false expectations are dangerous and harmful for the business climate.

Despite the globalization and integration processes and solidarity, it is basically a wrong governmental approach to put the Bulgarian business in a less favorable position in absorbing the EU funds. An example for such indecency are the regulations,



related to the so-called Silver fund. The National Assembly adopted this law, explicitly prohibiting the pensions guaranteeing fund to be invested at the national government securities market, which is actually a pure discrimination of the Bulgarian stock market. At present, stock exchanges abroad are not better capitalized and when it comes to investment, at least equal opportunities should be provided, not to mention the possibility for following a protectionist policy.

Another example might be given with the infrastructural projects' tenders and particularly, the road construction ones. These tenders are to provide and provoke European companies' participation as far as they are supposed to declare serious amount of guaranteed assets as well as a long run experience in the field of road construction. In terms of economic downturn, this sort of anti-national approach is extremely unacceptable. At least equal opportunities should be provided to the Bulgarian business to participate in EU funds absorption.

## **VASSIL VELEV**

*Chairman,*

*Bulgarian Industrial Capital Association*

The information, forecasts and analyses provided below are based mainly on observing the industrial and the capital markets. It is a well-known fact that 60 % of the Bulgarian export goes to the European Union. Bulgarian economy is small and open so at the beginning of the crisis this took it to less favorable position. The accumulated inflation differences between the EUR zone and Bulgaria amount at about 50 % since Bulgaria adopted the Currency Board Arrangements more than ten years ago. Some

negative affects are observable in Bulgaria due to these arrangements, although no other reasonable alternative exists. Therefore, governmental measures need to be taken for avoiding and moderating these negatives. Among these negatives could be mention the accumulated inflation differences, which so far were compensated by the growth of productivity. However, the potential for further acceleration in productivity growth is limited and this is one of the reasons for the large current account and trade balance deficit.

The crisis developed at lightning speed: while in September 2008 Bulgarian business still engaged labor force from abroad, in October 2008, it already started dismissing the staff. The November forecasts showed 30 % drop in industry for the first quarter of 2009. The same trend remained in January. The final data for January is already available (19 % downfall on a monthly basis) and supporting the mentioned above forecasts.

It is extremely important how we refer to the crisis. The public needs to be informed about the current situation but at the same time going too far with the negativism would discourage foreign investors. The role of the mass media here is crucial in order to prevent additional self-restraints of the consumption and further deepening of the crisis. It is important to know what the actual picture is and to trace out specific measures in due time.

The statistic data shows over 27 % decrease of the import during the first month of 2009, which is actually a positive effect of the crisis. The current account deficit has decreased with 45 % in comparison with January, previous year.

The overall forecasts concerning the sectors during the first quarter are described below. Thirty percent downfall is expected in industry. In metallurgy, machinery construction, mining industry and electrical engineering the sales are expected to be 50 %

of those during the last quarter of 2008. The downfall in textile and clothing industry would be with approximately 40 % (a little higher in the textile industry). Cosmetics are foreseen to be cut by 15 %. Slight increase is expected in some sectors such as pharmacy and food industry.

The crisis spreads unevenly at time and in depth. The first-level sectors were affected in its very beginning, then the crisis passed through the middle levels and yet has not reached the final-level sectors. The recovery will proceed in the same order. Regarding the differences in each country, there is no panacea for common recovery valid for each country. Bulgarian export decreased with 27 %, but the Japanese – with 45 %. This clearly shows the observable signs pointing at a global recession. In February and March within the firstly affected sectors, a decrease temporary restrained and once again, it became observable in the end of 2008. This stable trend is expected to remain at the very same level during the summer of 2009 and slight increase in the first level sectors is foreseen during the autumn. Specialists foresee a slow general recovery at the end of 2010. Bulgaria is not anticipated to reach its pre-crisis industry levels for the next two or three years at least.

In addition, fifty per cent increase of the budget sector salaries is extremely out of place, having in mind the revenue plan is unlikely to be fulfilled. As a result an increase of the administrative wages is absolutely ungrounded.

A few more factors contribute to the crisis' negative impact on the Bulgarian export. The competitive advantage for some outside-EU and Euro zone countries (Russia, Serbia, Ukraine, Romania, Hungary, etc.) could be improved by devaluation of currency up to 25 – 45 %. This approach is unacceptable for Bulgaria since it is performing within the Currency Board Arrangements and a fixed exchange rate against the euro.

Another difficulty for the Bulgarian export is generated by the unofficial but wide spreading protectionist policy led by some of the older EU member-states. Contrary, Bulgaria follows the World Trade Organization rules, though, a necessity of using anti-protectionism tools exists. Otherwise, the protectionist policy led by some older EU member-states along with subsidizing dumping import from some other outside-EU states may have crucial negative affects over the Bulgarian economy.

The stable positions Bulgarian economy still maintains are related to banking system and the sound public finances.

A tendency of transferring orders from countries within the Euro zone and the Dollar zone to Bulgarian suppliers is also observable. Lately the dollar gained ground over the euro and as far as the Bulgarian lev is fixed to euro exchange rate this brings certain competitive advantages to the Bulgarian producers. It is not a matter of new suppliers but if it comes to those already existing clients from EU and the USA, an optimizing of the supplies could be expected by increasing the Bulgarian share. Thus, strategic partnerships will maintain in the post-crisis times. Anyway, it would be a difficult year for the Bulgarian export and import. In this respect, there are a few measures that could mitigate the negative effects:

- The Bulgarian Export Insurance Agency's structure and its activities are not very popular. Currently we face delayed payments and even bankrupts of companies within old EU member-states. In this sense, extra security could be found in the export insurance the Agency provides.
- The capitalization of the Bulgarian Development Bank has been improved considerably. In this regard, its potential and resources are not used at the most, as well as the "exim" function that could and should be applied during the times of crisis.

- It is crucial and urgent also to economize on the whole foreign policy. The substitution of the honorary representation for the regular trade missions is also a way to reduce the expenses and the organizational efforts.
- The offset orders are not taken enough advantages of. When signing international contracts, a clause for counter purchase of goods should be included.

In general, these are the main recommendations of the Bulgarian Industrial Capital Association.

### **Kristofor Pavlov**

*Chief Economist,  
UniCredit Bulbank*

The global economic crisis transfers to Bulgaria through three main channels. All the three of them are relevant to the export:

- Difficult access to financing;
- Drop in the external demand;
- Lack of competitiveness.

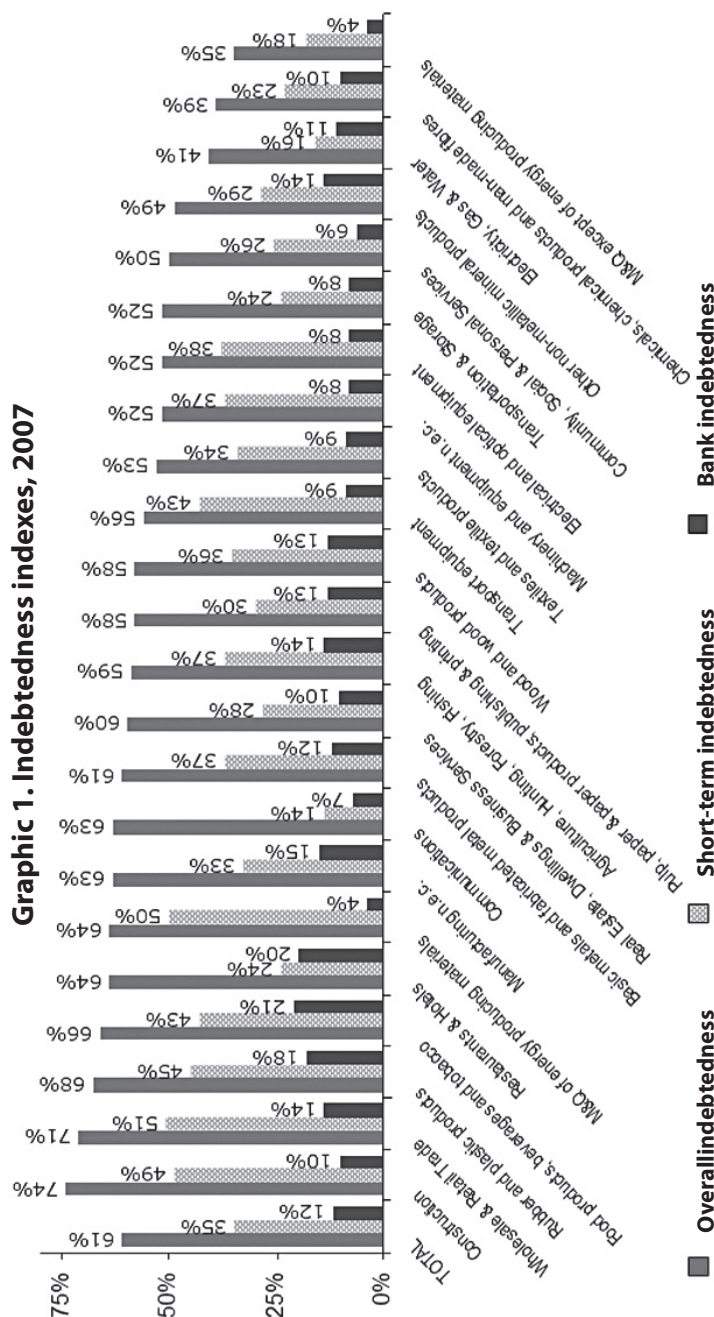
The latter concerns Bulgarian manufacturers of export products and is a result of the devaluation of the currencies of the SEE countries that have more flexible currency regimes. They are a direct competition to Bulgaria as they have specialized in the same products and aim at trading them off on the same markets.

***First channel*** for “import” of the financial and economic crisis to

*Bulgaria.* During the boom of the economy for the last couple of years, the access to finances was rather easy. A significant flow of foreign savings was observed in Bulgaria and that led to quick running into debt of all sectors. Now we are facing a situation of significantly difficult access to finances as the foreign savings flow shrunk in the last three months of 2008. A direct expression of this tendency is the decline of the Central Bank reserves that continues in the first months of this year. There is no reason to expect a change until the end of the year. Probably, we are at the beginning of a process that will continue in 2010. An expression of this difficult access is the increase in the prices of credits and all other forms of financing in the economy. It will influence the economy in two ways.

Firstly, it will force the companies to revise their investment plans for the following years since, on one hand, there is a difficult access to financing and, on the other hand – a decline in the external demand that will be supplemented by a drop in the domestic demand due to the deepening recession in the economy. That will make companies think twice about their investment plans and most probably the initiated projects will be put on hold.

Graphic 1. Indebtedness indexes, 2007



\*. Share of the liabilities outside the company's own capital in the balance figure;

\*\* - Share of the short-term debts in the balance figure;

\*\*\* - Share of the bank credit (including from non-resident banks) in the balance figure

Sources: NSI, UniCredit Bulbank, Economic Research

Secondly, the Bulgarian economy is in a considerable indebtedness, especially in a short-term perspective. This could be a challenge as it will be harder for the companies to re-negotiate their debts with upcoming days of payment in this or the following year. In extreme cases a higher rate of bankruptcies could be expected in sectors in which companies have allowed getting into indebtedness that endangers their solvency.

The National Statistical Institute data concerning the indebtedness of the Bulgarian economy from the consolidated sector balances show that in the end of 2007 in export-oriented sectors the overall indebtedness was lower than in the economy as a whole. The overall indebtedness consists of all attracted finances out of the company's own capital in comparison with the balance figure. In the end of 2007 the overall indebtedness of the economy was 61 %. On the *Graphic 1* the export-oriented sectors are in a frame, one can see that only in food and drinks the overall indebtedness is higher.

We have a similar situation with the banks' indebtedness. It forms about 12 % of the consolidated level of indebtedness in the economy. Again, the figures are higher only in food and drinks sector, but that is not uncommon as similar levels of indebtedness in this sector could be observed in the other countries from Central and Eastern Europe. It does not mean that the solvency of the companies in the sector is in risk.

However, the very high levels of short-term indebtedness are disturbing. They could be defined as "moderately high". A level of 35 % for the economy as a whole is really high. This means that the debts with payment days within twelve months are 35 % of the companies' balances. In extreme cases this could become a problem for certain companies.

Having in mind the current situation of the economy, the par-

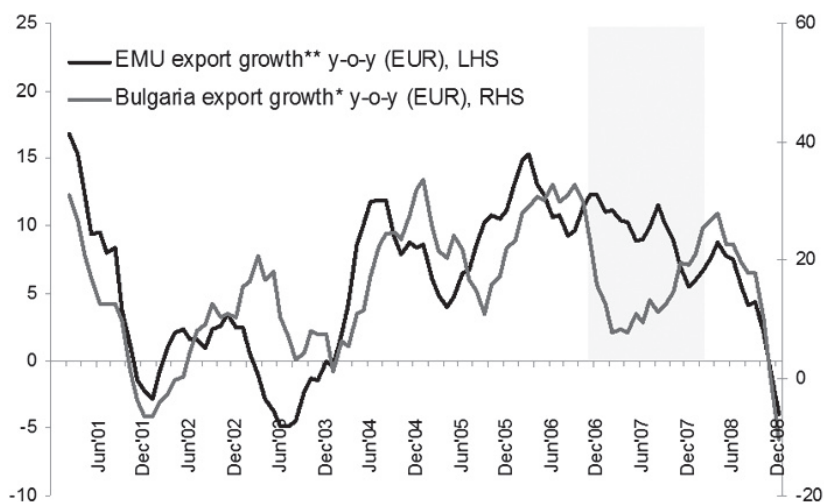


tial data for 2008 on a consolidated level might look decent but it could hide companies which indebtedness might represent a risk for their solvency. Thus, the prognoses suggest an increase in the relative part of bankrupted companies in the present and the following year.

***The second channel*** through which the global financial and economic crisis comes to Bulgaria is the slump in the external demand.

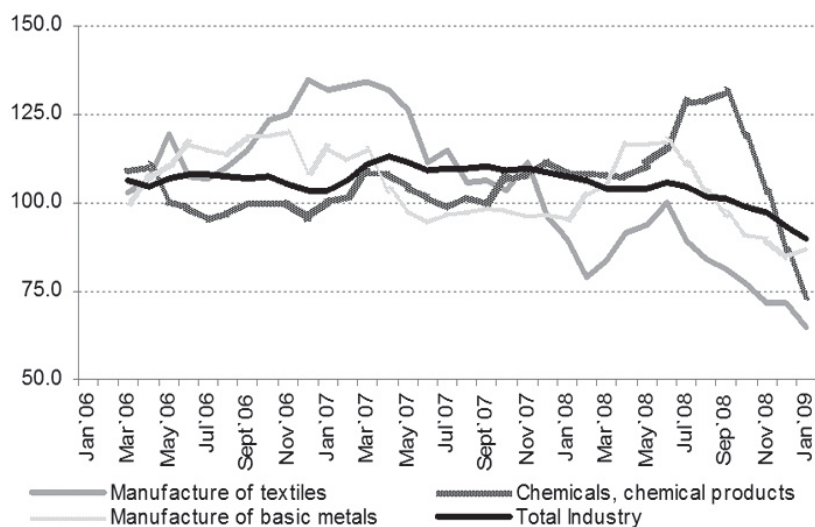
The growth in the export-oriented sectors in our economy is connected with that in the Euro zone. The rate of correlation between the growth on a 12-month basis for the Bulgarian export at current prices and the growth in export-oriented manufactures in the Euro zone is striking (data from the payment balance). The sole exception is the year 2007 when one-time factors influenced the Bulgarian economy. In 2007 there was a significant slump in the manufactured agricultural products. The vertically integrated sector for the production of food and drinks also had its impact on the country's export. Consequently, a situation in which the leading trade partners of Bulgaria are in recession leads to a slump in demand in all possible directions. It is on a wide basis, spreads to all fields and there is no way to prevent it from transferring to the whole economy. The data from the national statistics confirms this statement.

**Graphic 2. Export growth in the Euro zone and Bulgaria**



Sources: Eurostat, BNB

**Graphic 3. Changes in the production volumes of export-oriented sectors**



Source: NSI

Apparently, most vulnerable are the sectors that produce capital goods, machinery and equipment. Of course, sectors that manufacture long-term usage goods for the households will also suffer considerably. This means nothing but slump in demand for automobiles, computers, etc. Bulgaria will be influenced indirectly as it is specialized in the manufacturing of intermediate goods used in the production of the latter.

Other sectors that could be negatively influenced are those that are characterized by long cyclic recurrence. Their performance is immensely dependent on the performance of the economy as a whole. In the Bulgarian case, the sectors are those producing intermediate usage goods; chemicals; metals and textile, to some extent, when it comes to unfinished products. These sectors form about 50 % of the country's export, so the blow will be mainly on them.

Obviously, the sectors that will suffer least from the slump in external and domestic demand are the non-cyclic ones: food and drinks, other goods for daily consumption, pharmaceuticals. Signal verifying this thesis could be observed. These sectors form between 1/6 and 1/5 of the overall commodity export of the country.

***The last channel*** for the transfer of the global economic crisis to the Bulgarian economy is the devaluation of the currencies of numerous Central and Eastern Europe countries that have more flexible regimes for the exchange rates and that are direct competition to Bulgaria.

Main export-oriented productions of a country and their share of the overall commodity export are shown on *Figure 1 and 2*. In the second column are presented the main rivals that are specialized in the export of analogous products. In the third column, one may see how much these countries have devaluated their currencies since the beginning of the crisis. For example, in the food

and drinks sector that controls about 5 % of the export, the main competitors of Bulgaria from Central and Eastern Europe are the Baltic countries, Poland and Croatia. They have devaluated their national currencies by up to 40 %.

However, at present, the depreciation of the currencies in the region does not influence considerably the export of the relevant countries. For an instance, in the case of Poland that has most drastically depreciated its currency since the beginning of the crisis, there is no data showing any significant positive effect on the amounts that Poland manages to export. One could reach the conclusion that the slump in the external demand is so dramatic that even a considerable devaluation of the national currencies is unable to affect the drop in the export. Consequently, it could not influence the slowing down of the countries' economies that materializes itself through the channel of the slump in the external demand.

Presently, the currencies of the Central and Eastern European countries seem undervalued. A movement in the opposite direction is expected as soon as the global economy starts recovering and the global economic cycle starts improving. Then, they will come closer to the values defined by the fundamental factors in these economies. Despite this fact, no increase that could bring them back to the pre-crisis levels could be expected.

Figure 1. Channels through which the global recession influences the Bulgarian export – devaluation of the national currencies of CEE countries



Figure 2. Channels through which the global recession influences the Bulgarian export – devaluation of the national currencies of CEE countries



\*. share of the certain sector in the overall export in the first quarter of 2008  
Source: Eurostat, Global Insight, NSI

Consequently, Bulgaria as an economy with a fixed exchange rate has a problem because it loses competitiveness of the export-oriented productions. When having a fixed exchange rate, the recovery of the economic competitiveness happens through the labor market. In such occasions, one could observe slumps both in employment and in the nominal levels of the salaries in order to compensate for the lost competitiveness due to the fixed exchange rate. The unfavorable scenario that has to be avoided is the one in which the economy adapts itself to the new conditions and solves these problems only through employment reduction. This will make the process of accommodation of the economy very painful from a social perspective. In this respect, the measures adopted by the government are worthy of praise: to create stimuli for the companies not to dismiss workers, to switch to a part-time working schedule, etc.

Why is so important to quickly overcome the loss of competitiveness? Most analysts expect the world economy to start recovering in 2010. When it begins, our foreign trade partners from the EUR zone will have to make a choice in which Central and Eastern European countries to increase the orders for the production of various consummatives and intermediate usage goods. They will start with those countries that could offer lower costs and prices, that are more competitive. If, by that time, Bulgaria has not solved its problem with the lost competitiveness of the export caused by the devaluation of the currencies in the region, it might not be among the first to benefit from the recovery. The conclusion is that, if Bulgaria could not overcome this challenge, it will experience a longer recession in comparison with the other countries from Central and Eastern Europe.

This is a problem that we as a society are about to face in the following year and a half because the world economy is expected

to recover in the middle of 2010. Until then, the problem must be solved to a sufficient extent. Otherwise, it will be an obstacle for the competitiveness of the export and Bulgaria will not be among the first in Central and Eastern Europe to benefit from the recovery of the world economy.

## **Yasen Georgiev**

*Executive Director,  
Economic Policy Institute*

### **(Summary and current trends)**

It is beyond any doubt that the economic downturn in Bulgaria was imported and is not due to internal factors. Nevertheless, logically, the global crisis found its implications in the country, firstly through reducing the FDI volumes, which started already in 2008 and kept its pace with a different intensity during the whole year. Afterwards, the financial and economic turmoil resulted in shrinking of the Bulgarian export since the second half of the previous year. Thus, the lack of financial resources was followed by stagnation on the external markets and particularly on the most important one for Bulgaria – the EU internal market.

If in the beginning of 2008 one could have hoped that the global crisis would somehow pass over Bulgaria, in the mid of the second half of the year it was more than obvious that the country should prepare for harder times ahead, despite the outstanding economic performance in 2007 and the official statements and forecasts which aimed at maintaining calmness on the eve of the two forthcoming elections.

Some of the first indications of the impending challenges in front of the Bulgarian economy proved to be the signs pointing at ex-

port slowing down, which became evident in the third quarter of 2008. This trend sharpened in the beginning of 2009 and as a result the Bulgarian export registered a drop of 27 % for the first quarter and about 30 % for January – May 2009 in comparison with the same period one year ago. It is reasonable to think of even higher figures since the above-mentioned data of the National Statistical Institute has a preliminary status.

In this regard, it is useful to see how the export markets react and therefore, the latest available data, which concerns the first three months of 2009, should be taken as a basis. The export to the EU member states, which amounts to 65 % of the total Bulgarian export, decreased by 23 %. It is worth mentioning that the exportation to the old member states dropped by almost 25 % while to the new ones by 10 %. This lets one think that even lower figures are to be expected along with sharpening of the crisis in these SEE countries.

In accordance with the Bulgarian National Bank's latest data, a more moderate decrease of the Bulgarian export is to be observed also in countries like Russia, Ukraine, Moldova, Belarus, Switzerland and Norway where the volumes are smaller by approximately one tenth. Within the period January-May 2009 the biggest reduction is in Ukraine (almost 60 %) and Russia (32 %), while the Bulgarian production sold in Switzerland even grew by 11 %.

For the first three months of 2009 the export towards the neighboring Balkan countries shrank by 50 %. The breakdown shows volumes that are by 60 % lower when it comes to key export partner as Turkey, over 45 % to Serbia, 30 % to Macedonia and less than 6 % to Croatia.

Although some Asian markets registered certain growth, the Bulgarian export production to Asia declined by 30 %. For instance,



as of the National Statistical Institute, within five months the export to Indonesia increased almost three times and to Japan by a third. On the contrary, Chinese demand for Bulgarian goods reduced by 30 %. However, to be mentioned is data concerning the export for two important destinations for the Bulgarian export to the continent. To Saudi Arabia Bulgaria exported 93 % less than an year ago, while even a slight growth was registered towards Singapore.

Other relevant information for the export-oriented companies is which commodity groups were affected at the most by the stagnation of the external markets and the rising wave of protectionism.

According to the available data of the Bulgarian National Bank for January-April, the biggest drop within the Bulgarian export is to be observed in the energy resources – it exceeded 50 %. Sale of raw materials abroad decreased by 40 %. The following materials were hit most severely – fertilizer (-75 %), ores (-57 %), cement (-55 %), iron and steel (-52 %), chemicals (-46 %) and wood products, paper and paperboard (-37 %). Positive values, though, were registered when it comes to the export of raw tobacco (46 %) and raw materials for the food industry (23 %). It is exactly the volumes of food and tobacco that increased respectively by 10 % and 90 %. In spite of them the consumer goods group decreased by 7 % as a whole and even the growth in medicines and cosmetics export (15 %) was not enough to change the direction. The negative total figure is mainly due to the decline in export of beverages (almost 30 %), clothing and footwear (19 %), furniture and household appliances and others.

The aforementioned common trend did not skip the export of investment goods as well. Their overall decline (24 %) was a result of a smaller demand for machines, equipment, and spare parts on foreign markets. A mitigating effect was achieved through the growth rates in exporting vehicles (37 %) and electrical machines (7 %).

In times of declining foreign trade rates in Bulgaria one could witness a more accelerated slowdown by the import than by the export which results in improvement of the trade balance and reducing of the current account deficit. However, this should not be regarded even as a small achievement of the Bulgarian economy rather than a logical consequence of the present situation. Therefore, the times of crisis offer the most appropriate occasion for implementation of structural changes in the Bulgarian economy, which restructuring should foster export-oriented companies. To a large extent the crisis has just speeded up processes which country's economy was about to face sooner or later. Double-digit growth rates and quick profits are irretrievably gone and economic logic is about to return. It requires extensive forecasts and prognoses, investments that could be profitable at least in several-year terms, skillful management, etc. Furthermore, one should consider the decline and the rapid aging of the Bulgarian population and consequently a sharp decline in demand starting from food and beverages and ending in real estates. For that reason, drivers of economic growth in the future could be predominantly export-oriented sectors.

The reasonable question here is how to make Bulgarian companies successful abroad. Bulgaria still does not have any sector, product or service that is ultimately recognizable beyond its borders. The country loses its competitiveness because Bulgarian goods have to compete with these of countries which were able to depreciate their currency and now sell their production more advantageously. The country loses its competitiveness because of the lowest labor productivity in the EU. The country also loses its competitiveness due to insufficient investments in lifelong learning programs – Bulgaria occupies the last position in the EU-27. The country loses its competitiveness because the vocational and university education is not tied to the business needs. Last but not least, the country loses its competitiveness because of the brain-drain of more than 1 mln. young and well educated

people who have left Bulgaria since 1989.

Nevertheless, how could the Bulgarian export be competitive provided that in comparison with some EU countries Bulgaria does not rely on national champions, does not implement slogans as “Buy Bulgarian” and at the same time is exposed to protectionist environment.

First and foremost, the Bulgarian image abroad should be polished and a lot has to be done in order to create a brand out of Bulgaria – if not from the whole country, at least from certain sector or production lines. No matter how difficult it looks from today's point of view, there are two channels the Bulgarian companies could use to make their goods and services popular abroad. On one hand, it could be reached by improving the functions of the Bulgarian trade representations, which are currently subordinated to the Ministry of Economy and work in rather bureaucratic than business manner. On the other hand, a more efficient use of the international fairs and exhibitions should be initiated that, though, is a very costly measure. In this regard, when it comes to agricultural products and food, a more considerable attention should be paid to EU support for their promotion where eligible activities are participation in fairs and exhibitions, tastings, TV, radio and print advertisements, etc. These programs for promotion of EU agricultural products are directed both towards the internal and external market.

Despite the present difficulties, there are many appropriate examples of Bulgarian companies which operate on foreign markets where they compete successfully with multinational corporations and local players. What is more, these are not only companies which exported their production before the 1989 change. Therefore, one could conclude that the most essential thing Bulgaria has to change is the way of thinking. A way of thinking from inside towards the world outside, not from the point of view of a small Balkan country but from the perspective of a EU member state which, despite and exactly because of

# CHAPTER THREE

## **IMPACTS OF THE GLOBAL CRISIS AND THE ROLE OF NATIONAL GOVERNMENTS**

## **Florian Fichtl**

*Country Manager,  
World Bank, Sofia*

The overall assessments are changing to the downsides as the International Monetary Fund (IMF) is revising its estimations and the World Bank is now predicting negative global economic growth in 2009 for the first time since the World War II. In these challenging but also interesting times, the interventions by the governments are constantly changing.

In December 2008, the Gross Domestic Product (GDP) growth of the entire world was still estimated to 1 %. This is no longer just a prediction and the sharper adjustments in commodity prices are not disputable. Globally, private capital flows are expected to decline in the future and in this situation Bulgaria shares the faith of some other countries that have pursued prudent policies and nevertheless found themselves exposed (for example Germany). On the positive side, the public finances are in good shape in Bulgaria. The public sector balance sheet is strong and the banking sector is very capitalized and profitable. However, the global recession will not leave Bulgaria unscathed. It will affect the country through three channels. Export and capital flows will decline. The larger the decline, the larger the drop in growth will be. This brings up the question how should policies adapt.

These are very general policy recommendations. It is prudent for Bulgaria to maintain fiscal surpluses; it is important that wage growth is not exceeding productivity gains because last year in an overheating economy wage growth exceeding productivity gains impaired the competitiveness of Bulgaria. Additionally, Bulgaria was well advised to maintain the health of its financial sector. For a small open economy, the room to maneuver in fiscal policies is very limited. With the currency board *de facto* this is simply not an option.

In the discussion only last year it was a big question- why not to spend the fiscal surplus, why to maintain it? It is related to the currency board: because maintaining fiscal reserves provides confidence to investors in the banking system and because fiscal stimuli are not likely to be effective in a small open economy. In order to maintain large surpluses, when the revenues are declining and very clearly expected to decline, spending them also needs to be reduced. Given these considerable uncertainties on the downside, nobody could predict in March what the year and revenue will be. So, certain buffers, certain caution are well advised.

Government has instituted this ten per cent rule and it is a prudent measure that requires monitoring on an ongoing basis. The ten per cent rule is also a good idea because the original budget forecast was based on a larger GDP growth that will not take place now. Wage growth needs to slow. Wage growth in the past was driven mostly by the private sector not the public sector. The government has already limited wage growth in the public sector. The underlying question is what the size of the public sector is, what the scope of mandate is and what the remuneration for the competent public sector is. There are number of issues to be addressed.

Given the limited room to maneuver and the difficult regional and global situation for Bulgaria, it all comes down to increasing the efficiency of spending and accelerating structural reforms. Accelerating structural reforms is necessary to maintain competitiveness of the public sector. Increasing the efficiency of spending will help make the most out of the existing revenues. This seems now more important than ever. Therefore, the crisis also provides an opportunity to advance the reforms. Modernization is really on the agenda in the dialogue with the government and all partners in Bulgaria. Sometimes, it is observed that it is difficult to implement reforms in a period of expanding budgets

and economic growth and a kind of counter intuitively it is easier in difficult times. Therefore, perhaps this is now an opportunity to advance some strategic reforms. If there is a requirement to reduce expenditures, across the board cuts are one way to deal with it and it will satisfy the bottom line and meet the objective. However, if one takes a look at more substantive issues, it will be better to go about implementing efficiency gains in a more structured manner rather than across the board cuts.

When a country faces a crisis, it should keep in mind the economic recovery and at all circumstances protect expenditures, which safeguard the long-term productivity and competitiveness of an economy. Along the same lines, renewing expenditures functions as high priority public investments and very importantly ensure that the social safety net is functioning. Stock market decline might as well as the unemployment put a strain on the pensions and for Bulgaria we would expect the possibility of efficiency gains in the health sector.

In relation to the labor market, its flexibility is important in terms of economic upswing and downturn. It is also important to protect the workers and not unnecessarily their jobs. For Bulgaria, resuming the convergence to EU average incomes, it is important to raise labor force participation. If one takes a look at employment rates data from 2007, he will see that for the age group 25 to 55 employment rates in Bulgaria have advanced to EU average level. That is the good news. On the elderly population – 55 to 65 there is room for further increasing participation. Of course, this is difficult at that age. Strategically more important is the 15-25 years group that is lagging considerably behind EU levels. This directs the attention to the education system. If we look at the quality of the education, it is well known that Bulgaria scores higher according to the PISA literacy levels (as lower you are ranking as higher the literacy level in your country is), which is not good news. Therefore, if we think about investments in the

social sector, education is one of the sectors to be protected. This is one of the areas for the government to continue investments, to continue modernizations. Particularly important are vocational education and training as well as tutorial education system.

With reference to the economic recovery, if we look at the current situation where global investments in general are declining, countries depending on foreign direct investments have to strike very competitive environment to attract these reduced foreign direct investments. It will be important to maintain a solid investment climate and to improve it. This is also true for Bulgaria which has done very well in terms of the investment climate overall, in terms of tax policies and tax administration, but there is still considerable scope for further improvements. The areas that should be highlight are the regulatory regimes, which are complex and burdensome. One might also want to add the judicial sector. Improvements in the performance there would also benefit the private sector. The other area in line with the Lisbon agenda is innovation and research and development. At various occasions World Bank has analyzed the sector and has made recommendations to improve the way these resources are spent in order to contribute at most to the development of the private sector.

In conclusion, it is clear that 2009 and 2010 will be challenging for all countries in the world, for Eastern Europe and also for Bulgaria. In a world with little appetite for risk tolerance for slippages in terms of the reform agenda will be minimal. Fortunately, Bulgaria has a track record of strong policies and there is a basis for confidence that this tendency will continue.



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*President,*

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### **1. What kind of crisis we are facing?**

The crisis came out as a result of several factors. It started as a financial crisis. It has certainly something to do with overproduction of goods but also of liquidity - in China particularly but not only there (in China several sectors were already injured –i.e. car industry is). It means that there was also overproduction in the financial market. The lack of regulations contributed largely to the outbreak of the crisis. It is also an institutional crisis because it develops in a world where the economic power balance is completely different from the one that had been assigned to the voting rights of the main economic powers several decades ago in the leading international organizations. Thirdly, it is a geography-related crisis because particularly Europe feels as a growth centre for the time being and probably for a longer time the center had shifted from Europe to Asia and the Pacific region.

It has to be added that this crisis, in contrast with the previous ones, has developed in the developed world and immediately hit about 60 % of the world GDP. So, earlier plans and illusions that there will be certain countries like China, India, Latin America and even Russia, which would maintain a very high growth rate and which would be able to bail out the world economy on this crisis, have to be discarded. If 60 % of the world economy is in this crisis, there is no other bailing out possibility than huge cuts in the current social security systems of all the developed countries. If the politicians are not ready to do it, we will not get out of the crisis. However, particularly at a period of deepening economic

crisis, there is no politician who would make this kind of suicide but we all will be suffering from it.

The second remark – the crisis has different levels and we have already most fully experienced the financial aspect; we are in a deepening economic crisis, although we have not reached the bottom line yet. It will be a deep, long crisis everywhere in the world, and not least in Europe. Next, the certain level is just now unfolding. We do not know now how deep the social crisis will be and finally we will have to reckon also that there will be an ideological crisis as a result of the economic recession, social sufferings, real income cuts, higher level of unemployment, etc. In all these areas, again how deep this crisis will be in the different levels largely depends on the role of the state.

## **2. The overwhelming theory and economic practices concerning the role of the state**

Meanwhile, the neoliberal ideology pleaded for very limited role of state, if any. State intervention was considered very harmful. Unfortunately, the crisis made it clear that market does not function properly without a certain regulatory and institutional system. Therefore, we have to stay far away from any kind of liberal ideas, which is a bad thing because a lot of the liberalism would be needed for the market to function correctly. What has been one of the basic points is that the banking sector should be completely exempted of regulations and of state intervention. Nevertheless, what we see today is not only state intervention everywhere – direct and indirect, but what we see is a capital crime according to the liberal theory and particularly in those countries, which were main propagators of the liberal theory – the USA and Great Britain where the state has already nationalized part of the banking system.

Finally, the liberal theory also stated that the lower the recentralization of the GDP is in the state budget, the better it is as it is not crowding out private capital. However, we see it is not a new phenomenon. What really does matter is not the share of the recentralization through the central budget in GDP, but what is really important is how the state is spending the money, which is recentralized. Scandinavian countries have a very high level of recentralization (over 50% higher than in any other European country) and they are doing quite good. In the structure of the expenditure, there are three areas, which have very clear priority, and all of them are future-oriented: very heavy investment in education, a similarly heavy investment in research and development and innovation and again heavy investment in health. These are the three factors of reproducing the high quality of human resources, which is the critical element in sustainable competitiveness all over the world.

The question of what kind of state we will have in the future is very difficult to answer. It will be a stronger state but we do not know what will be the quality of it. Hopefully, we will not return to the classical traditional interpretation of the role of the state as father state of social subsidies and nationalized and patriotic economies. If we happen to come back to this, our perspectives and forecasts for the future would be extremely gloomy – much gloomier and darker than our current evaluation of the situation.

### **3. Examples of direct or indirect state interventions**

There are different forms of state intervention as a result of the crisis. First of all, we have to make a differentiation between direct and indirect intervention. Direct intervention is where the state is as a state participating in the assets of a company. The indirect is protection, stimulus for economic recovery, damage limitation and some kind of a patriotic economic policy, which is extremely question-

able in Europe that is supposed to have a single market. If we have a single market, all these patriotic policies would destroy its normal functioning. Secondly, state intervention can be differentiated according to sectors – banking, on one hand, and manufacturing, on the other. We have seen in the banking sector a very strong, to some extent justified, direct intervention of the state not only by recapitalization and nationalization of banks but also by giving separation of toxic assets and by giving guarantees to deposits. Much more controversial is the direct intervention of the state in the manufacturing sector and here again we should make a difference. One case is the construction sector where some of the investments could be started a year or two earlier in order to maintain or moderate the higher unemployment. If resources are available, it could be supported. However, the intervention into the manufacturing sector, particularly the car industry, have had a very dangerous spillover effect on several other parts of the economy. An intervention in the car industry will immediately affect about 30 to 40 other industries that are its subsidiaries, which are supplying it with different inputs – from rubber to plastics, from electronics to steel. The third element when we talk about state intervention is the time frame – is the intervention transitional or is it lasting? We know from previous experience that nothing is as long-lasting as the transitional measures. If something is transitional, what kind of vested interests will be strengthened and even if the state withdraws from the given sector, what kind of structure will remain there? Will this structure be more competitive or more protectionist than the previous one?

#### **4. International context of the role of the state**

National states are in a process of globalization and there are some areas and challenges, which are unlikely to be successfully faced by the nation states. The regulatory and institutional components of the crisis were mentioned beforehand and both

of them need an international solution, even if there are nation states that are participating or in case of the EU – just the union. Regarding the EU as an international context for all of us, right now it is experiencing direct bailing out activity in the banking sector, indirect intervention to some other sectors and some recovery plans, which have already been announced.

What the crisis has shown is that in the first period and even today, unfortunately, nation states pressed by their national electorate, by politicians, seem to follow the old and the highly unsuccessful and risky road which the economists took through the first oil crisis in 1973 – everyone for themselves and God save the strongest. That is certainly not helping but that is what we have seen.

We are much beyond the EUR 200 bln., which was communicated by the EC, but at that time in December, already EUR 170 bln. of it came from the national rescue plans. It had nothing to do with the common coordinated European policy. EUR 30 bln. could be more or less attributed to the EU- EUR 1 bln. to the European Investment Bank and the other part to the rest of the residual EU budget. What has become clear is that the monetary and the fiscal policy of the Union could not be harmonized. At the beginning, in 1990-1993 when the monetary union was lounged everybody was convinced that sooner or later the monetary policy will automatically lead to more fiscal policy coordination. It did not happen but more importantly the whole set of instruments of the Union has not been prepared for crisis management.

After 50 years of EU integration, nobody has been able to introduce into the EU an instrumentarium or some kind of a policy mix in order to manage crises. Crises management remained on the national level. We see today that very much against the common economic theory and partially due to the lack of common European policy, the US dollar, which is the currency of an economi-

cally weak state, has gained ground against the euro. The US did not resist the temptation of including about USD 45 bln. just in one year in order to rescue the US banks not by US money, not by taxpayers' money in the US but through the so called hostile savior state funds. That is how political ideology is giving ground to economic rationality. The danger is that world financial markets will become empty and then any kind of European recovery plan will face the same difficulty in finding money, as it is now the case with some Central and Eastern European countries. It can become easily a universal or European situation.

The third remark on the international context is the attitude and reaction of the transnational companies to the crisis. The transnational companies did not take a definitive decision until now. They are fluctuating between two possibilities - one is to look around in the world, look at their subsidiaries everywhere – from Brazil to Russia and from Bulgaria to Ireland and see which are the most competitive ones and which are the least competitive ones. If they follow the economic rationality, they will have to close down those factories and activities that are the least profitable. If these companies happen to be in the so-called mother countries of the transnational companies, then these will have to be closed down. The other temptation is that they will give priority to the national bailout plans and then will maintain jobs in the less competitive areas and the less competitive locations. Then, they will have to close down those that are more competitive, which will be a loss of competitiveness not only during the crisis but also in the post-crisis situation.

## **5. Future oriented remarks on the potential alternatives seem to be the most important ones**

The state will certainly have much more important role in managing and remedying the negative social and budget consequences

in the future. The talk is mainly about recovery and bailing out plans but in most European countries budget deficit will become much higher than the 3 % and that is just the beginning of the story. It will be rising and rising in the next couple of years. It could be managed at this moment if in the process of deepening recession old member countries such as France, Germany, let alone Ireland or Spain would cut social expenditure in the amount of 2 to 3 % of GDP. But that is politically impossible. Therefore, they will be facing a huge budget deficit with inflation pressure in the next years.

The second problem is the growing difference just because such plans have to be carried out eventually and they cannot be carried out in a short period. Structural changes in the economy and in the budget need a longer period and here the political and the economic rationality are practically confronting each other. The economic rationality is that if we have a reform of the healthcare system or the public administration or tax policy, it needs about 6 to 10 years in order to have its full positive impact. The political rationality is that as far as we are living in a democracy of 4-year electoral cycle we have to do everything in 4 years. That is impossible and that is why big economic reforms have always been swept under the carpet in the last 20 years.

The last threat is the potential ideological impact – particularly in the Central Eastern European countries. Practically we all have made a very rapid liberalization of trade and capital flows in an unprecedentedly short period. No doubt there was no other way in the period of globalization but if we now see that the state is taking back its role, state intervention is coming back in those countries which try to teach us how to behave in a market economy. We have already privatized much more to foreigners than the Western European countries did. It can create such an ideological backlash, which would be the hot bath of the worst kind of populism with all the consequences not only on the given country but also on the European stability.

## **Georgi Ganev, PhD**

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For Bulgaria, the crisis is mainly imported. Except for a few segments of the construction, there are no inner reasons for crisis in any other sector. The crisis entered the country via two channels – a decrease in the capital flows and a drop in the foreign trade turnover, especially in the export, but for Bulgaria the slump of the import has economic significance as it is connected with quite a few business branches. We have problems with the budget revenues, real production and especially in the industry but on the other hand, we report a considerable decline in the inflation rate. Thus, in near future Bulgaria may switch from concerns about high inflation to worries about too low, maybe even deflation. It is of crucial importance to the real sector. The crisis that started globally from the financial sector, could affect the Bulgarian financial sector via the real one. In this way difficulties for our financial sector may occur but we should not forget that it is still very well capitalized and even profitable at least according to the last data available.

From a Bulgarian perspective, government policies could be discussed from the point of view of the classical economic theories. According to the one promoting strong state intervention, the state supports the economy by various measures – increases in the budget expenditure, deliberate cut of the budget income and lowering of taxes. For instance, in the fiscal plan of Barack Obama one may clearly discern both of the components. For a small open economy with a currency board it is naive to believe that the fiscal expenditures will be efficient. They might have positive short-term impact but they could not support the economy in a long-term perspective.

Bulgaria is in a state of fading economic growth, which was fos-



tered mainly by the enormous foreign capital influx in the country. In this respect, the main state policies should be directed to the management of these capitals. Surely, the net influx of capital decreases but the challenge is to regulate the process so that the economy could accommodate itself to the unfavorable developments in the global economic environment.

Firstly, the budget surplus and its maintaining certainly improves the country's situation and image, especially when it comes to decisions from large international companies where to withdraw from and where to stay.

Secondly, hereby, the European funds policy is important and due to the recent underperformance, there are considerable reserves towards Bulgaria. Even a slight improvement of the way Bulgaria administers the European money and the money of the Bulgarian taxpayers would considerably improve the influx of this capital – a sizable amount of which is currently frozen.

Thirdly, with reference to the trust in the Bulgarian monetary regime and in the country in general and regarding the net influx of capital, it is again important for Bulgaria to achieve considerable success on its way to the Euro zone. To a large extent, it is a matter of policy-making. By all means, it is an important policy because in a fixed exchange rate regime the country pays a high price for its maintenance and in the current situation it is crucial to actually benefit from at least some of the advantages. In order to keep and even attract new foreign capital in Bulgaria, it would be helpful to observe a palpable move towards ERM II within the year. Of course, the health of the financial sphere must be maintained; presently, it is well capitalized and profitable. There are buffers both in the fiscal reserve and in the currency board reserve of the National bank, so this money should not be spent on anything else. Thus, anyone willing to play on the Bulgarian market will be sure that at least the financial system is stable and

no cataclysms will be allowed.

If we go back to the inflation issue, two important policies stand out. When there is a very low inflation rate or even deflation, the flexibility of the factor prices, in this case mainly the labor costs, becomes crucial for the competitiveness and for the opportunity to adapt to the unfavorable conditions. In this respect, if necessary, the labor market policies of Bulgaria should provide possibilities for wage flexibility, even downwards. In a long-term perspective, Bulgaria has a relevant advantage because it does not have rigid systems that literally forbid the wages to go downwards, in contrast to many developed countries. It must be absolutely clear that wages in Bulgaria could go down in nominal values in order to maintain competitiveness and to improve productivity of labor.

Other flexibilities that are important in times of crisis are the barriers for entering and withdrawing from the market. The instruments available in Bulgaria for compulsory and voluntary withdrawal of companies from the market are in poor conditions when it comes to legislation, insolvency and bankruptcy procedures for companies. "Kremikovtsi" is a typical example of these weaknesses. In a crisis environment, firms need to leave the market due to the strong competition at the lowest possible social cost in terms of time and resources spent on decision-making. Of course, the social cost that will be paid by those left without jobs is a serious problem. However, in times of crisis these processes should not take too much time because the most important thing is for the vital enterprises in the sector to have access to the free resources.

## **Stefan Tsvetkov**

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In the current exposition under state of crisis, we will understand a state in which regular instruments for macroeconomic policy do not function anymore, problems occur usually for the financial system of the country and in that situation the main institutions in charge of the macroeconomic stability concentrate on the bailing out chiefly of the financial system. In this sense, Bulgaria is not in a crisis as the financial system is stable and does not need salvation. A slowing down process could be noticed but the situation is under control and the basic macroeconomic instruments used for the management of the economy still work. Actually, the main problem for the government and for all people who work in the sphere of macroeconomic policy is to maintain the status quo of the country; to keep it under control and not to allow any form of crisis. The main priorities of the macroeconomic policy are stated in the last state budget that is a fact. In the budget, one could find explicit regulations about public expenditures and instruments intended to keep the macroeconomic stability – to run 3 % budget surplus in order to maintain the stability of the currency board and to keep the public expenditures within 40 % of the GDP. The treasury in particular has undertaken the obligation to make expenditures up to 90 % unless it becomes evident that there is no problem with the maintenance of the previous parameters.

Due to various reasons, the economic picture at the time of the budget drafting was quite different from the present one. The surplus will probably be maintained by all possible means as long as it becomes urgent to make the most important public expenditures. From that point on, the budget surplus becomes a problem for the economy and it prevents the automatic stabi-

lizers from functioning. Thus, in a certain macroeconomic situation this surplus could be reduced under the most important condition – to maintain the stability of the currency board. Of course, there are some priorities set in order to keep the economic growth – certain public expenditures must be made; cares for the environment and the flexibility of the labor market must be taken as they are really significant, especially when going out of the crisis.

For 7 years, Bulgaria has maintained very high growth rates. With a few exceptions, they were around 6 %.The momentum for them was the unusually high investments growth rate. Investments reached record-breaking levels as part of the GDP. Almost 40 % of the GDP are due to investments. This is an unsustainable investment level and a decline should be expected even without the financial crisis. Investments growth rate is anticipated to shrink dramatically, it might even turn negative.

These investments were stimulated in various ways. The credit growth, the fierce competition for market shares among the banks and the consequent low interest rates were also of help. Of course, there was certain enthusiasm among investors who obviously were in a state of competition. As a result a huge amount of capital was accumulated in the economy and to some extent it did not correspond to the available labor force. The effect was a strong slump in the unemployment rate that went from very high levels (18 %) to around 5 % in a few years which, considering the structure of the population is a very low level for the Bulgarian economy. This is definitely under the equilibrium levels. Despite the intensive growth, in Bulgaria one could observe certain misbalances in the economy. Actually, the budget surpluses accumulated year after year were used as brakes for these processes. The National bank increased the compulsory interest rates to 12 % and undertook a few other steps for reducing the credit growth.

In the last three months of 2008, however, the economy slowed down noticeably. In practice, industrial sales have been shrinking considerably since August. The National Statistical Institute already published the data for the last three months growth rate – 3 % and accordingly 6 % for the whole year. Obviously, the slowing down will continue at least for the following quarters. Largely it is connected with the negative shock that comes from abroad via the export. The export sales drop very dramatically. The wage problem was automatically transferred as a result of the labor force shortage. Wages rose significantly. It is widely acknowledged as a serious problem of the economy when wages go ahead of labor productivity rates. These are more or less middle-term tendencies, which were most clearly visible in the past two and a half years. The most noticeable follow-up was acceleration of the inflation, especially in the last year, which also reached very high levels before the international prices collapsed in August last year. So, again due to an external shock prices slumped drastically and at the moment we are expecting deflation. There are still a few points to be reached before deflation appears on our territory. Presently, the inflation is around 5 % and it is not considered as very low yet.

The main indicator revealing any misbalances in our economy is the current account deficit. It reached 25 % of the GDP, which is extremely high regardless of the indicators used. One cannot avoid interpreting it as growing risk for the economy. The most important question that interests home and foreign analysts is what will happen if the money that finances the current account deficit suddenly stops. First of all, it is worth mentioning that during the last years the current account deficit was very well financed, a huge amount of money flowed in the Bulgarian economy (EUR 8,5 bln. direct foreign investments in 2007; EUR 6,5 bln. for 2008 according to preliminary data). Additionally, enormous financial flows were accumulated via loans and deposits in the banking sys-

tem, which eventually lead to considerable extension of the currency reserves – about EUR 15 bln. at the highest level. We should pay attention to the fact by no doubt this rapidly increasing current account deficit was due to the huge amount of money that entered the country and largely stimulated domestic demand. The main issue at hand is whether the existence of a current account deficit combined with a potential suspension of financial flows could represent a threat for the stability of the currency board and the banking system. This threat is not as great as one may initially perceive it looking at the 25 % current account deficit. Actually, the answer lies in the very structure of the Bulgarian current account: huge trade deficit, comparatively stable service level as well as two more items – incomes and transfers.

What will happen to each of these items if the financial flows seize? The answer is that it will considerably slow down domestic demand and import of goods, which will lead to shrinking of the trade deficit. However, these events will not endanger the stability of the currency board but it will question the economic growth. Provided Bulgaria is in a state of recession but not of crisis, the economic policy instruments will continue to function. The seizure of the financial flows will affect the trade and the economic growth but not the stability of the financial system. The same applies to the service sector.

Two issues deserve special attention, the first one being the national foreign debt. Its structure consists of very large debt to the private and very small to the government sector. Thanks to the budget surpluses in the last years, at present, the foreign debt is around 15 % of the GDP which is a very low level even considering the Maastricht criteria. Thus, the national debt is not a problem. Nevertheless, what happens to the swiftly increasing foreign debt? One could observe that the private debt service, both bank and non-bank, is very low year after

year which means that it has been incurred under very profitable conditions and consequently, it presents no big risk to the currency board.

In the same way, FDI that reached very high rate – EUR 30 bln. lead to the flow out of profits, which also affects the current account of the payment balance. Nevertheless, the flowing out also seems under control (4 % of all investments). In our point of view, the currency board will probably experience some pressure but under items, in particular, there are no signs of any critical income flow-out levels that could endanger the whole financial system. Of course, it would be quite unfortunate, if due to some reasons we observe flee of capitals from the country. However, it has to be connected with extraordinary circumstances, which seems unlikely at this point.

### **Nadya Yorgova**

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#### **(Summary and current trends)**

Until recently, there were no disturbing indications within the economic forecasts on Bulgaria. The country still remains an attractive investment destination. Some of the main reasons are as follows: low taxes in comparison to the other states in the region, yet low costs for qualified working force, relatively low power costs. However, these positives should be only considered in short and medium terms. As long-term obstacles for foreign direct investments flows should be considered the administrative burden, institutional inefficiency, poor infrastructure.

A positive signal to the investors is also the stability presented

by the national budget surplus. On the other hand, it provides a proper functioning of the currency board and the financial stability. However, the budget balance at the end of the year may turn debatable, since the government in power undertook a number of anti-crisis expenditures. Final estimations and up-to-date balance of the budget are yet to be done, but it is inevitable to restrict some of the expenses. It will be of great importance to the new government in power to give an answer to the question of which articles in the budget need cuttings. Moreover, this should maintain stability and provoke an economic growth but also should not oppose the current social policy followed and oriented to building qualified human capital.

**Table 1**

Main macroeconomic indicators	2008				2009
	I quarter	II quarter	III quarter	IV quarter	I quarter
GDP real growth rate (%)	7,0	7,1	6,8	3,5	-3,5
Industrial sector (%)	7,7	7,2	2,1	-3,7	-12,4
Service sector (%)	8,3	5,8	6,4	3,8	2,5
Exports of goods and services (%)	9,2	5,1	3,8	-6,0	-17,4
Imports of goods and services (%)	5,8	13,7	4,2	-3,2	-21,1

**Table 2**

Month 2009	January	February	March	April	May
CPI*(monthly growth rate, %)	0,8	0,1	-0,2	0,7	-0,3
CPI (12 month growth rate, %)	7,1	6,0	4,9	4,8	3,9

*Sources: BNB, NSI, MF*

Recent macroeconomic dynamics and data for the first quarter (according to the National Statistical Institute (NSI), Bulgarian National Bank (BNB), Ministry of Finance (MF)) forecast future obstacles and worsen business climate, which will transmit



the crisis in Bulgaria even more notably. Some of the main concerns, demanding strong governmental interferences are related to the national economy and the channels through which crisis affects it. They consist in decrease in GDP growth, lower Foreign Direct Investment, difficult access to financing, decrease in exports, increase in unemployment rate and other effects related.

Looking at the numbers (See Table 1), one could easily notice that the Bulgarian GDP real growth rate is declining within the first quarter of 2009. Within the same period, the decrease amounts to 3,5 % (y-o-y). It needs to be underlined that this decrease in GDP growth is measured on previous period basis and concerns the 1<sup>st</sup> quarter. This clearly shows that the crisis already affects the economy. Within the GDP growth decrease, the services sector still grows (though not that intensively as in the last year). Meanwhile the industrial sector's data is shrinking and forecasting serious problems. The value added of the industrial sector (y-o-y) is constantly decreasing from the last year middle and reaching the threatening decline of 12,4 % for the first quarter of 2009.

According to Table 1 data, the growth of imports and exports of goods and services also turned negative from the middle of the last year. However, a positive influence could be found in the currency account deficit, which decreases, since the import is declining quicker than the export.

Another sensitive issue is the inflation rates in Bulgaria. It remains on main, unfulfilled and disputable criteria on Bulgaria's way towards ERM II, respectively to the Euro zone. With its high rates of inflation during the last year, Bulgaria considerably stood above the referent rates, ECB defines (see Table 2). Still, it is assumed that these three countries are among the best de-

veloped ones within EU and on the other hand, Bulgaria would hardly reach their overall rates (inflation included), considering the low basic position, it obtains.

The high level of FDI in the state since 2007 clearly indicated the same, and it resulted in a higher rate of GDP growth. It is logical to assume that the lower inflation rates are positive (in crisis even deflation is foreseen). On the other hand, the index itself for Bulgaria is far beyond the defined by ECB referent rates of 2 % “healthy” inflation within the Euro zone. In this manner, a deflation could be considered a disturbing signal for the economic stability of the EU. Reasons can be found in few directions such as lowered energy and oil prices, decrease in the domestic demand (to a high extend based on increased unemployment rate expectations) and lower rate of loans issued. Unfortunately, these processes are too threatening, having in mind that while an inflation spiral is dangerous, the deflation spiral may appear even more dangerous and both of them are likely to reproduce themselves and lead to recession.

Regarding the price indices (see Table 2), the variation amounts to -0,3 on a monthly basis. However, on a year basis, the same index is 3,9 %. This fact shows relative stability that Bulgaria maintains.

On 5<sup>th</sup> of July, 2009 the Bulgarian society voted for a general change resulting in a change from socialistic-based to a center-right cabinet. Generally, such politically oriented cabinet is supposed to implement a less governmental role and more liberal ideas. On the contrary, one can observe more and intensive crisis-provoked governmental intervening (direct and indirect), regardless of the political parties in power. The matter of how and how much the new government will intervene in the given macroeconomic dynamics described above is still to be observed. Anti-crisis measures to be taken by the new parliament will be

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<sup>1</sup> Political party GERB anti – crisis program issued at 10 May 2009

examined in more details below<sup>1</sup>.

Several points are given as priorities. Firstly, the measures include a permanent dialogue among the government, business and labor organizations. Such a measure is undoubtedly needed since the public opinion and expectations need to be correctly formed within the crisis situation. In this regard, it is crucial for the proper information to reach the masses, since in times of crises the public opinion may become extremely sensitive. Example to be given is the lack of trust in institutions in the dark years of 1996-1997 deep financial crisis, when the negativism reproduced itself and led to worsening the economic situation in general.

Another undoubtedly necessary measure is an actualization of the state budget and its harmonization with the new governmental priorities and goals. Such a move is needed as the budget itself is a "picture" of the economic situation. However, the basic economic indices have already deviated from the numbers set in the budget

Also, an affect is expected to be observed as a result of some pre-election campaign expenditures. That will probably influence upon the budget fulfillment. On the other hand, cutting the expenditures must be considered very precisely. Otherwise, the budget buffer's price may turn out to be unreasonably high. It might threaten the labor productivity by low educational and qualification capacity, bad health services, lower human capital quality and bad labor market state. In this manner, it will be crucial to find a balance between budget revenues and expenditures without depriving of strategic expenditures.

Another important role in the budget forming has to be played by the EU funds. Some of the main reasons pointed for freez-

ing these financial sources are the broken dead-lines, lack of transparency in their management. Sharp measures in their future management are decided to be as follows: review of all the procedures, reporting them and turn to the prosecution; increase the audit and monitoring authorities' capacity; starting the anti-crisis measures according to the Operational Programmes (OP), developing the quality of performance within the OP Regional Development in regards to the municipalities' road network. Which of these goals shall be reached is still to be seen within the EC decision on whether to unfreeze the funding and to what extent.

Within the measures, regarding the labor market, there would be programs, developed for transferring employees from the mostly affected sectors (e.g. construction) to agricultural sector (assumed to have much more room for development). Certain measures here are once again focused at EU support, partial or total. This is another issue reminding the necessity of worming the Bulgaria – EU relation and the measures to be taken in this direction, which could provide or avoid the chance for Bulgaria to participate in the common policies led.

Turning to the budget revenues, the future policy-makers aim at lowering the tax and health insurance burden up to 5 %, this would result in higher disposals, provoking higher economic activity. There are taxes and administrative procedures relieve also foreseen, aiming at opening working positions and increasing the potential investment activity. Although these measures are practically and theoretically proved to be effective, the budget balance needs to be a goal demanding higher direct and indirect tax revenues.

In crisis situation, it is also crucial to improve the business climate. For quicker and less painful exit of the crisis, it would be

of a great help, if the program observed above is successfully maintained. The new government in power needs to find lower administrative obstacles and higher institutional capacity. Improving the business climate and the social environment could be also supported by investing in effective construction of infrastructure. Such social acquisitions are positive for the national well-being but still, the expenditures must be properly defined and coherent to the social measures for gaining well educated, qualified and quality human capital which remains a long-term goal.

To what extent the new cabinet in power will succeed in fulfilling its anti-crisis goals depends on many different factors. Still, one is for sure – either the vote will be justified (even if it is partial) or the economic stability and prosperity forecasts for Bulgaria will go far beyond the x-axis.

# CHAPTER FOUR

## **THE IMPLICATIONS ON THE LABOR MARKET**

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The channels through which the global financial and economic downturn is transferred to Bulgaria also include country's labor market. The scheme through which we expected the negative influences to affect the country includes few interrelations. The need of extra workers will be reduced by the expected decline in the economic growth and even more – it may appear a need of reducing the work force in some sectors and industries. On the other hand, this will lead to higher overall unemployment rates. Moreover, in the current situation, the unemployment rate is different for the different state regions and as a result of the crisis these proportions are expected to deepen seriously. A decrease in the planned investments in human capital such as different trainings and increase of the wages is another aspect of the crisis' influence. For compensating the external negative effects, another crucial issue is the insufficient flexibility within the labor market.

In the beginning of this year, a governmental action plan for the employment was adopted for compensating the external influences on the labor market. Using its tools, we have unemployment rate registered at 6,5 % in the beginning of the year. This means that the registered vacant positions are 1800 more than those registered for the same period previous year. The expected inflow of unemployed is 12 000 for February. This is also the result of mass dismissals. In this perspective it is that the employers prefer not to dismiss the workers on a mass scale rather than doing so with small groups but systematically and regularly. This way they are not obliged to announce that at the employment bureau for taking the necessary measures.

This makes it quite obvious that we will observe gradual increase in the unemployment rates and the number of spare labor force

on the labor market. The Ministry of labor and social works takes the measures necessary to prevent long lasting unemployment of dismissed workers. Thus, we aim at preventing the loss of any abilities and competences of the dismissed employees. An example of the envisaged programs for lowering the deficit of workers in different sectors, which started in 2008, can be given. We started with the sector of tourism, construction, and sewing. But then information about dismissals on a mass scale was received and it appeared that our expectations did not match the real circumstances. As a result, these measures reformed and a new program was deposited in the Observation Committee.

Coordination with the Observation Committee is necessary for taking given measures within the Operational Programme on "Human resource development". As far as EC representatives are involved in the Committee, we found a new scheme on "Qualification services and encouraging the employment". Within its framework, we provide an education for the unemployed ones for obtaining and improving their qualification. The priority of this framework will be given to the unemployed within the vulnerable groups. The main goal of this program is related to the successfully passed ones to be involved in a permanent employment. Of course, this is based on the researched employment opportunities.

During this current economic downturn, we have run another program, providing qualification of the dismissed as of 01.11.2008 employees, related to enterprises went bankrupt, internal restructures, shrinking the capacity or shredding parts of the production lines. In this relation, it has to be kept in mind that some serious funding is available under the Operational Programme on "Human resources development". The program itself, consisting of eight priority axis, amounts to EUR 1.2 bln. altogether. Since the economic downturn will not last forever, we must make good use of this resource for improving the work force capacity. Otherwise, in some sectors we would face a deficit of qualified personnel.



There are few open calls for applications within the Operational Programme. The first one is qualification services for employees. Everyone could apply for this call – an enterprise or a firm, training organization which would like to improve the qualification of its employees or to define the area for development of employees. The program is very helpful because of the diverse influence it could provide. It includes only providing a professional qualification which is the most popular practice both on national as well as on supra-national level. Moreover, this financial tool gives the opportunity for the employees to obtain key competences, to study languages. These are competences, which used to be prioritized and nationally granted. Nowadays, the companies have the chance to receive the resource needed for improving their employees' profiles.

Another scheme, related to unemployed young people up to 29 years old, was started. They shall be trained in key competences such as obtaining computing skills and having a command of languages. Another scheme aims at the group of people above 50 years old in order to be in line with the EU common policy regarding the lifelong learning.

The European Commission declared its readiness to take part in the creation of new anti-crisis measures to be implemented. Among the interesting ideas could be found the creation of "green" working places. The Commission is very open-minded and expects us to make the assessment of the current situation and what could be useful in this regard. There is a readiness the maximum donation thresholds to be increased in case that would be useful for overcoming the negative influence over human resources.

All the measures are related to the European Employment Strategy and the goals set within it. The same could be observed in the renewed Bulgarian National Employment Strategy, aiming at improving the capacity of the working force, keeping the employment rates, combining the work experience with the family

life. Last but not least is the achievement of the so-called flexibility, which has to provide all of the opportunities that the flexible working hours could give to as more people as possible. This would lead to a part-time employment, only not as a step towards a painless dismissal of personnel but undertaking the guarantee for keeping their jobs. The situation has lately been very dynamic and the government and the policy followed is aiming at flexibility and influence at each stage of the labor market development.

### **Alexander Zagorov**

*Confederational Secretary,  
Confederation of Labor "Podkrepa"*

The state creates a better picture in the country by complementing certain resources for the employment of people in risk. Real jobs and real employment could be found only where there is real production. The impact of the crisis on the companies reflects the labor market. We must declare explicitly that Podkrepa supports the thesis that we need competitive economy and enterprises. In these enterprises, our trade union organizations are reliable partners that together with the employers and owners work for the company's future. They by no means lose their trade union identity because their main activities include labor right promotion, income increases and creation of better working conditions.

We use new terms as quality of life, quality of the working environment, labor well-being. Hopefully, it is not just a terminology adopted from the EU but a jargon that is successfully integrated into our reality. Working from a distance, self-employment, flexibility, lifelong learning – these are also new terms that set new directions. All these activities combine in one dynamic process.

Trade unions take part in the social dialogue on national, regional and branch level and also have representatives in the companies.

Their organizations are natural bridges between policies from the national documents and the business circles. Unfortunately, the social dialogue in our country is inefficient and takes place only for the sake of appearances. Therefore, after such inferences the Confederation of Labor Podkrepa and the Confederation of Independent Trade Unions in Bulgaria left the National Council for Trilateral Cooperation.

Bulgarian trade unions are not yet unanimous about the instruments necessary to react to the crisis. The word goes about analysis, observation, etc. At this point, we do not know whether the crisis is temporary or it will become a way of life. At present, there are various opinions and positions expressed publicly. However, when it comes to mass redundancies and working time reduction, trade unions become rather sensitive. Unfortunately, recent observations do not give us reasons to be optimistic. Actually, the crisis is expected to spread in a distinct way and monitoring of mono industrial productions is necessary, especially of those related to the regional development (ore output, metallurgy). In most cases, the whole infrastructure of such regions is centered on these productions. There are many multinational companies whose behavior we could not predict well enough. According to different statistics, SME comprise 97-99 % of the enterprises in the country. In this situation, as trade unions we are unable to carry out extensive research but wherever we have trade union organizations, we try to make forecasts and to support those companies that generate sustainable employment.

In times of crisis, one of the directions possible is to intensify the civic dialogue or the bilateral one between trade unions and employers. Steps have already been taken to improve the quality and the frequency of the internal dialogue because trade union organizations are public networks that spread on national, branch and regional level as well as in the companies.

What is also crucial in crisis conditions is to know what is life-saving. In this case, bailing out of the recession is only possible through successful human resources management. It is not in the capacity of a sole employer or of the state alone. Therefore, the dialogue creates opportunities for the participants in the labor market to clarify their interests, to discern the tendencies, to express their points of view and eventually to adopt applicable political decisions.

In conclusion, the crisis is a system of risks – risks that are both in the labor market and in those who play on it. They could be observed and thus managed. Trade unions try to participate in these exact processes through the dialogue.

### **Vladislav Goranov\***

*Economy and budget expert*

The crisis originates from the fact that at certain point money that never actually existed simply disappeared. A liquidity crisis followed and it later transformed into a consumption crisis. The insufficient consumption questions the economic theory of supply. Presently, it is a challenge even to produce something let alone something that is actually demanded. Bulgaria does not have large companies as Nokia, Mercedes, BMW. In the given situation, it is natural for the labor market to suffer because industrial relations consist of capital and labor. Capital already passed through serious difficulties and now it is time for the social cost to be paid. What is unique for the Bulgarian labor market is that employees from the construction sector do not enter it which is attributed to the existence of illegal employment. In this respect, Bulgaria stands a relative chance as it has significant reserves on the informal labor market. The role of the state is to continue applying pressure aggressively to the shadow economy, giving the

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\* Since July 30, 2009 Vladislav Goranov is appointed Deputy Minister of Finance.

real, sustainable business mechanisms a chance to survive. This way, it will create new, additional opportunities for the treasury and will curb the unfair competition that suffocates those knowing how to do business.

There is very limited space for direct subsidies as a tool to influence labor market. The measure proposed by the trade unions – governmental granting, could have been acceptable, if we knew that the crisis will last for exactly three months. In this period, provided the government allots these BGN 120 and we know in the forth month the company will be stabilized, such a measure could be justified. But when we all know that the crisis will continue for at least two years, subsidizing could only bring about irrational expectations without real positive results.

Until now, everybody sought only general description of the situation without making any proposals for specific solutions. The maintenance of useless budget surpluses, when the current account will no longer be a problem, is not a solution. It is another story that the planned surpluses will not be reached because the budget was drafted in completely different circumstances. What could be done is to leave the money to the economy instead of making inefficient public expenditures. Thus, this liquidity and consumption crisis will provide those who know how to do business with another chance. The state will not be in the position to restore those markets and businesses that have already disappeared. Provided the GDP is about 70 bln., even if we spend the fiscal reserve of 8 bln., the figure is slightly more than 10 %. This money will be enough to supply the economy for two or three months. Therefore, the better choice is to leave this money to the people in the first place.

Naturally, the state must not resign from the welfare benefiting of the most vulnerable groups – those who cannot enter the labor market due to their social status. Those who are just about to leave the market should not be abandoned, too. The agency should

study which sectors need labor force in order to avoid misbalances in labor force demand and at the same time talk about a crisis in employment. Presently, there are 40 thousand jobs available but nobody takes them. Here comes the role of the state with its 1 bln. and 200 thousands as well as with better research on labor demand and supply. This correlation should be created because otherwise we may mix unemployment with the labor force shortage.

### **Iskra Beleva, PhD**

*Deputy Director,*

*Institute of Economics at the Bulgarian Academy of Sciences*

In order to manage the processes, one needs to be closely familiar with their genesis and also with the factors that provoke them.

Labor market enters the crisis in a relatively stable state. At the same time, it does not enter it in a perfect shape as the labor market has been producing problems for years. They concern mainly youth and long-term unemployment as well as many other misbalances that will most probably flourish in this specific crisis situation and will influence labor market in one way or another.

The external stresses for the labor market arise predominantly from the changes in the GDP, in the amount of foreign investments, in the import and export and in the domestic demand. Undoubtedly, the most important factor for the employment growth is the GDP and its dynamics. For a period of ten years Bulgaria suffered from a huge crisis in the labor market which dates back to the beginning of the transition period and the recovery started only in 2002 when we first witnessed positive increase in employment (four years after the GDP growth, so the lag is significant). Despite the differences in the nature of the crisis and

the whole situation, the country gained some experience that should not be forgotten when it enters once again into the difficult part of the cycle and its negative effects on the labor market. For the period 1998 – 2008, the impact of the average 4,5 % GDP growth on the labor market equals 733 thousand jobs created. Maybe in 2000 – 2008 the effect was even stronger as there were almost 400 thousand new workplaces created. Generally, 1 % growth was tantamount to 70 thousand new positions. These figures suggest powerful influence of the GDP dynamics on employment. For the 1990 – 2008 period the figure is 0,56 % which means that about 31 % of the jobs came from the growth. For 2000 – 2008 it increases to 37 %.

Investments are a key factor in creating employment and it is time to remember what the policy in 1990 – 2000 included and how the 18 % unemployment was addressed in 1993. The government started with stimuli for the SME and the self-employed. Then, it switched to the regional programs in search of local effects, to the UNDP programs, to the World Bank intervention and its policy advice and when foreign investments finally started to increase in Bulgaria, they become the impetus for employment development. The latter forms a strong correlation (correlation factor of 0,65 or about 72 % of the workplaces came from foreign investments).

Undoubtedly, the other really important factors are import and export, especially export. Naturally, a slump in export is sure to have impact on employment, mainly in export-oriented sectors. Nevertheless, we should seek opportunities for restructuring of the export flows and possibly search for alternative markets.

The internal problems of the labor market exist within the framework of long-term unemployment, discouraged people and quality imbalances. Discouraged unemployed form a solid group of 152 thousand that lie by (October – December, 2008) and do not play on the labor market but now, when demand decreases

and supply increases, they will once again come forward together with the biggest problem – long-term unemployed (of whom 60 % have attended only primary school). This is the quality expression of the imbalance in the average annual rate between newly employed and redundant for 2008. These people remain unemployed simply because their quality features do not meet the requirements of the labor demand.

Experts are unanimous that employment will decrease and unemployment will increase accordingly but they are rather diverse in their views of the rates. However, in general, 1 % unemployment in January 2009 equaled 37 thousand jobless people.

Possible counteraction policies should be oriented to the external factors and to the influence on their negative impact. Although the government came up with its proposals, there is no consolidated position or vision what policies will actually be implemented. The good news is the search of continuity in the basic principles of the packages proposed by the government. The diversification of packages also shows a flexible approach – provided some packages prove inefficient, the instruments that they embody need to be transformed in the fastest way possible. What is missing in the packages and what are the problems? The first great danger comes from the opportunity to use the problems in the labor market in order to promote demands and claims that have existed for years. Everybody who keeps abreast with the market is familiar with the discussions about the burdens to the labor market, to the legislation and to the flexibility. However, there are no argument-supported assessments of what the proposed measures will actually lead to and why they have to be favored in the first place. From this perspective, one has to be extremely cautious and even suspicious when it comes to the variety of ideas in the public. In a situation of risk, one has to be a true adventurer in order to also play hazardously. Maybe it is wiser to stay calm and to keep the movements moderate.



Nevertheless, there are a few positive aspects to be drawn from the crisis. Eventually, the current conditions could be used for a kick-start of the long-protracted restructuring of the labor force. Construction sector will shrink and illegal employment will come out of the shadows. Possibly, it will help the sector find a more efficient labor structure by dismissing unqualified workers and by keeping the quality labor force. And those who lose their jobs will have the chance to requalify or improve their skills in the field.

The time has come to talk more about how to increase the competitiveness of the Bulgarian economy – by more efficient restructuring and definitely not by adopting flexible instruments, including wage-reduction. One must question the thesis that Bulgaria should gain competitiveness by highly qualified but cheap labor force. Actually, this is already just a myth and unfortunately, it was not the best position for the Bulgarian labor market.

To begin with, we have to discharge those direct correlations present, so that we could increase our competitiveness in a state of currency board. We must use all channels for increasing administrative and process management efficiency: of production, of labor force management, of its contribution in the production management and in this way to seek reserves for the labor force quality.

**Kalin Marinov**

*Executive Director,  
Economic Policy Institute*

### **(Summary and current trends)**

Undoubtedly, the labor market is one of the most vulnerable segments of the national economy during a period of recession and market instability. In the last nine months this principle is

visible and completely expected in Bulgaria. With the appearance of the first peripheral waves caused by the financial crisis in the USA and Western Europe, the unemployment rate in the country began to increase steadily despite some of the short-term measures undertaken by the Bulgarian government. Furthermore, after the record low levels of unemployment rate varying from 5,5 % to 5,8 % in August and September 2008, an increase of two percentage points is registered in July 2009.

The downward trend of increase of the economic growth of Bulgaria was inevitable even without the existence of the global crisis as in its eve the national economy has already showed some indications of overheating and many of the sectors were working over their marginal norms. The inflows of FDI, which during the first half of 2009 registered decrease of approximately 40 % in comparison with 2008, were characterized by some basic factors. The most visible feature was the fact that most of the investments were directed towards earning rapid but unsustainable profit – financial mediation and construction. It could not be said that the typical process of industrial migration from Western to Eastern Europe took place in Bulgaria as the cases of major international companies which transfer a significant part of their production process in the country are still rare. Such permanent allocation of foreign investors in Bulgaria could be a trigger for the development of corporative policy towards the human capital and R&D in the private sector.

The effectiveness of the labor market and perquisites to become a source of competitiveness for the whole national economy could be determined by the following factors. The first step is to be measured the level of qualification of the labour force. The implementation of national policies emphasizing predominantly on the life-long learning and the prequalification hides some risks of accelerating the trend from the recent years of constant decrease in the average level of the acquired knowledge and skills by the

youth after graduating from secondary schools. Such way of programming of the national priorities could provoke an emerging of a closed cycle. Instead of providing additional qualification to the individuals after they graduate from secondary school and universities, this kind of programs are in a way directed towards the weaknesses of the educational system. In fact, these weaknesses should not be tackled on individual level but on the level of improving the educational system as they have deepened in recent years.

Another important factor, which influences directly the effectiveness of the labor market is the labor legislation and the established insurance framework. The obstacles here could be outlined in terms of the regulation of the part-time work contracts. The level of the employees of part-time contracts is around 2,8 % in 2008<sup>2</sup> and this is one of the lowest levels in the EU. Only Slovakia registered lower level at approximately 2,7 %, while the Netherlands hold the highest share at about 47 %. The countries which joined the EU in 2004 and Romania have values of this indicator varying in the gap between 4,6 % and 9,9 % and there is a common tendency, contrary to Bulgaria, for a slow decrease or keeping the same levels.

Reforms are also needed in the labour legislation in the field of fixed-time contracts. Improvement of this component would allow more accurate planning of the corporative and project expenditures and would raise the level of labour mobility. In Bulgaria, within the period 2005-2008, the levels varied between 5 % and 6 % while the average level for the EU was approximately 14 %<sup>3</sup>. Usually this index is higher in national economies with well developed sectors with seasonal character such as agricultural sector, food producing, tourism and construction. Currently, the Bulgarian Labour Code allows a second fixed-time contract to be signed with the same em-

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<sup>2</sup> Data source: EU

<sup>3</sup> See EURstat stat

ployee only once for a period of one year. This is a great burden to the business as in some cases the firms need to employ worker for one or two months and they are obliged to do that for a one-year period. The European Commission also provided the Bulgarian government with prescriptions to undertake some measures to ease this regime.

The worsening of the economic reality provokes an increase in unregistered employment, contrary to the tendency of bringing the labour market out of the grey sector in the recent years. After the achievements in this aspect, reached as result of the implementation of the 10 % flat tax and the abolishment of the non-taxable minimum, now the trends are in the opposite direction. The effects of eventual implementation again of the non-taxable minimum will be in fact a “step backwards” and will stimulate registration on the lowest possible salary threshold as the rest of the amount will be paid without announcement in the tax agency. At the same time, the positive effects of this measure will be limited to the very low number of employees which are actually registered on this lowest threshold of the salary levels.

The only possible amendment could be the decreasing in the insurance burden to the employees. However, this is a very risky approach in the current situation of high government expenditures.